

**Before the  
Federal Communications Commission  
Washington, D.C. 20554**

In the matters of	)	
	)	
Multi-Association Group (MAG) Plan for	)	CC Docket No. 00-256
Regulation of Interstate Services of Non-Price	)	
Cap Incumbent Local Exchange Carriers and	)	
Interexchange Carriers	)	
	)	
Federal-State Joint Board on Universal	)	CC Docket No. 96-45
Service	)	
	)	
Access Charge Reform for Incumbent Local	)	CC Docket No. 98-77
Exchange Carriers Subject to Rate-of-Return	)	
Regulation	)	

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River Communications, LLC, and TDS Telecommunications Corporation**

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River Communications, LLC, and TDS Telecommunications Corporation**

ALLTEL Communications, Inc., CenturyTel, Inc., Madison River

Communications, LLC, and TDS Telecommunications Corporation (the “Joint Commenters”) hereby submit the following comments in response to the Commission’s Notice of Proposed Rulemaking (the “Notice”) in the above-captioned proceedings.<sup>1</sup>

**I. Introduction.**

The Joint Commenters in this proceeding are midsize incumbent local exchange carrier (“ILEC”) holding companies that specialize in providing a full range of high-quality voice and data services to Americans in small cities and rural areas throughout the country. Collectively, the Joint Commenters serve approximately 5 million lines, largely in rural and small urban markets in 38 states. Most of the Joint Commenters’ operating companies qualify as

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<sup>1</sup> *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No. 00-256, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, FCC 01-304, 16 FCC Rcd 19613 (2001). The Report and Order portions of this document will be cited as the “*MAG Order*.”

“rural telephone companies” under the definition contained in Section 3(37) of the Communications Act of 1934.<sup>2</sup> Most are regulated under cost-plus rate-of-return regulation, including some that are “average schedule companies, *see* 47 C.F.R. § 69.606, although one operating company, Aliant, is a price cap carrier affiliated with ALLTEL.

The Joint Commenters are actively deploying broadband Internet connectivity in rural America and deploying digital subscriber line (“DSL”) service wherever economically feasible throughout their markets, in addition to high-speed data, frame relay, ATM, and other advanced services.

## **II. Summary.**

In this proceeding, the Joint Commenters urge the Commission to:

- Create a five-year transitional incentive-based alternative rate regulation that rate-of-return carriers have the option to elect on a study-area-by-study area basis;
- Immediately eliminate the price cap all-or-nothing rule that prevents rate-of-return carriers from electing price cap regulation in those study areas where price cap regulation makes sense;
- Carefully consider its goals in developing incentive rate regulation for rate-of-return carriers, taking into account the demographic, technological, economic, legal, regulatory, and market forces that rural carriers face today;
- Adhere to the following principles when developing incentive rate regulation for rate-of-return carriers:
  - Incentive regulation should reward carriers for choosing to enhance and expand the capabilities of America’s rural telecommunications infrastructure;
  - Incentive regulation should afford an opportunity for increased earnings commensurate with the increased business risk electing carriers face;

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<sup>2</sup> 47 U.S.C. § 153(37), as amended (the “Communications Act”).

- Incentive regulation should provide support for new investment;
- Incentive regulation should permit market pricing of certain services;
- Consumers, interexchange carriers (IXCs), and competitors should benefit from their carrier's election of incentive regulation; and
- Reform of interstate access rate regulation should proceed hand-in-hand with reform of the jurisdictional separations process.

The Joint Commenters believe that, by applying these principles, the Commission can create a form of incentive-based alternate rate regulation that promotes the deployment of advanced services and other infrastructure in rural America while attracting a reasonable number of carriers that currently are regulated as rate-of-return carriers. Doing so will benefit rural America by promoting efficient competition while requiring minimal enforcement and monitoring intervention by regulators.

### **III. Incentive Regulation for Rate-of-Return Carriers Should Be Optional by Study Area and Transitional over a Five-Year Period.**

#### **A. Incentive Regulation Should Be Optional.**

The Joint Commenters recommend that the Commission permit rate-of-return carriers the option to elect (or decline to elect) participation in any alternative regulatory plan that the Commission adopts, on a study area-by-study area basis. The Joint Commenters believe that the diversity inherent in the nation's rate-of-return ILEC community compels this level of optionality.

*First*, remarkably wide diversity among rate-of-return carriers as measured by varied population densities, line count, service territories, customer bases, cost characteristics, and product mixes means that it would be impossible to develop an alternative regulatory plan

suitable for all rate-of-return ILECs, their geographies, and customers.<sup>3</sup> Rate-of-return carriers have tiny study areas that serve small communities in the Alaska bush wilderness (e.g., Circle Utilities with 33 lines), but they also include study areas like Commonwealth Telephone Enterprises which, with nearly 300,000 lines, is one of the largest study areas in Pennsylvania.<sup>4</sup> While some of the smallest telephone companies have unseparated common line revenue requirements on a per-line basis that rival the lowest-cost BOCs, others range up to many thousands of dollars annually, due to the rural and high-cost areas they serve.<sup>5</sup>

Thus, there is too much variability, both in the size of rate-of-return carriers and in the areas they serve, to require any rate-of-return carrier today to commit, in total, to a single alternative regulatory plan.<sup>6</sup> As the Commission correctly explains in the Notice, “[g]iven the

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<sup>3</sup> See generally Rural Task Force, *The Rural Difference*, White Paper #2 (January, 2000) (“*Rural Task Force White Paper #2*”).

<sup>4</sup> Universal Service Monitoring Report, CC Docket No. 98-202 (rel. Oct. 2001) at Table 3.27.

<sup>5</sup> Filer Mutual Telephone Company in Nevada, for example, with 804 lines, has an unseparated common line revenue requirement of only \$106.71 per year, rivaling Bell Atlantic-DC. The highest-cost companies, by comparison, range up to and beyond \$6000 per line annually. *Id*; see also, e.g., *Rural Task Force White Paper #2* at 51 (“The average Total Net Plant Per Loop for non-Rural Carriers is \$860, as compared to \$1900 for Rural Carriers. The range of values for Rural Carriers (\$360 to \$29,200) is far greater than for non-Rural Carriers (\$205 to \$529). This is confirmed by the large relative variability of the Rural Carrier Total Net Plant Per Loop (107 percent) compared to the non-rural value of 24 percent.”)

<sup>6</sup> Those that can do so effectively have already elected to participate in price cap regulation under the *CALLS Order*. See *Access Charge Reform*, CC Docket No. 96-262, Sixth Report and Order, FCC 00-0193, 15 FCC Rcd 12962 (2000) (“*CALLS Order*”). Further, there is evidence that price cap regulation on an all-or-nothing basis has not been an unmitigated success for companies such as Citizens, Valor and Iowa Telecommunications. See generally “Reshaping Rural Telephone Markets,” Legg Mason Wood Walker, Inc. (Fall 2001) (*Legg Mason Report*); Emergency Petition for Forbearance of Iowa Telecommunications Services, Inc. (filed Nov. 26, 2001) (seeking target rate increase to fund investment in new plant, equipment, and services, as well as forbearance from rule under *CALLS Order* requiring

wide variations among rate-of-return carrier operating conditions . . . , it would be extremely difficult to establish a mandatory alternative regulatory plan for all rate-of-return carriers.”<sup>7</sup> For precisely this reason, the Commission declined to make price cap regulation mandatory for any carriers outside of the BOCs and GTE.<sup>8</sup>

*Second*, the Commission must recognize that rate-of-return carriers that operate multiple study areas should have the option to elect incentive regulation by study area. This level of flexibility is essential because variations exist within rate-of-return carrier holding companies that mirror the variability in the rate-of-return carrier community at large. Even within the Joint Commenters’ operations, for example, ALLTEL’s smallest study area, ALLTEL New York – Red Jacket, has fewer than 2,800 lines while its largest, ALLTEL Georgia Communications, has over 325,000 lines and is the second-largest study area in that state. CenturyTel has even greater variation; its study areas range in size from tiny CenturyTel of Chester, Iowa, with 221 lines, up to CenturyTel of Washington, with approximately 180,000 lines. Similarly, TDS study areas range from just over 100 lines (Asotin Telephone Company, Oregon) to approximately 64,000 (Tennessee Telephone Company). Madison River study areas range from approximately 12,000 lines (MebTel, Inc.) to over 85,000 (Gallatin River Communications).<sup>9</sup>

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price cap carriers to elect within 60 days of the release of the order to choose the CALLS plan or to set interstate access rates at forward-looking cost levels).

<sup>7</sup> Notice at ¶ 227

<sup>8</sup> *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6818, ¶¶ 257-265 (1990) (“*LEC Price Cap Order*”), *aff’d sub nom. National Rural Telecom Ass’n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

<sup>9</sup> See Universal Service Monitoring Report, CC Docket No. 98-202 (rel. Oct. 2001) at Table 3.27 (all statistics).



*Third*, as a result of this diversity, any optional incentive-based alternative regulatory plan for rate-of-return carriers should have flexibility to accommodate the wide variety of environments in which rate-of-return carriers operate. To preserve, enhance, and encourage expansion of the capabilities of rural networks, the Commission should develop incentives tied to quality of service and the availability of desired network capabilities, rather than focusing simply on carrier costs or rates.

As part of any alternative plan for regulating rate-of-return carriers, therefore, the Joint Commenters urge the Commission to conclude that alternative regulation would be optional on a study area basis. Such incremental election will permit rate-of-return carriers to gain experience with alternative forms of regulation, and grow more confident that alternative regulation is viable for a greater number of study areas.

**B. Incentive Regulation Should Be Transitional Over a Five-Year Period.**

The Joint Commenters also recommend that the Commission adopt an alternative regulatory plan for rate-of-return carriers on an interim, transitional basis, for a term of five years, which permits additional study areas to opt into such alternative regulation at any time during the life of the plan. The Commission has now developed ample precedent for doing so,<sup>10</sup> and such a transitional plan will encourage election by carriers but permit the Commission,

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<sup>10</sup> See *CALLS Order*, 15 FCC Rcd at 12977, ¶ 36; *Jurisdictional Separations Reform and Referral to the Federal-State Joint Board*, Report and Order, 16 FCC Rcd 11382, 11391-92, ¶¶ 15-17 (2001) (“*Jurisdictional Separations Interim Freeze Order*”); *Federal-State Joint Board on Universal Service, Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking, 16 FCC Rcd 11244, 11259, ¶ 30 (2001) (“*Rural Task Force Order*”).

carriers, and other interested parties alike to evaluate technological evolution and market changes over the course of the plan.

With telecommunications technology and markets evolving rapidly, a five-year transitional plan will create a much-needed period of stability on which carriers can base their business plans, while affording the Commission the chance to evaluate whether its rules continue to reflect industry realities. As the Commission explained in the *CALLS Order*, it adopted the CALLS Plan as “a transitional plan that moves the marketplace closer to economically rational competition, and it will enable us, once such competition develops, to adjust our rules in light of relevant market developments.”<sup>11</sup>

In response to the Commission’s request for comment,<sup>12</sup> the Joint Commenters would therefore support the Commission’s adoption of a limited one-way-door rule that would require any study area that participates in alternative regulation to do so at least for the remaining life of the plan. Such a one-way-door rule should, correspondingly, sunset five years after the plan takes effect, permitting study areas to withdraw after that time. If the Commission adopts such a one-way door, the Joint Commenters believe that the Commission should also adopt a procedure whereby a carrier may obtain an adjustment in the event that its earnings fall below 10.25 percent, or if other good cause arises, such as a weather-related or man-made event that causes catastrophic damage to the network that could not be repaired with revenues available under alternative regulation.<sup>13</sup>

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<sup>11</sup> *CALLS Order*, 15 FCC Rcd at 12977, ¶ 36.

<sup>12</sup> Notice at ¶ 227.

<sup>13</sup> This type of failsafe mechanism is consistent with longstanding principles that ratemaking should not be confiscatory. *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307 (1989).

#### **IV. The Commission Should Not Relegate Rural America to Second Class Telecommunications Services.**

As explained below, while price cap regulation may have benefited some areas of the country, price cap regulation has largely failed rural America. Price cap regulation, as currently structured, is largely unworkable for the majority of the nation's 1,300+ rate-of-return ILECs. Moreover, price cap regulation has been a failure in most rural exchanges served by the nation's mandatory price cap carriers. For over a decade, some have abandoned their rural exchanges instead of making any significant network investments. Today, the face of telecommunications in rural America is dramatically different from the one the Commission evaluated when it designed price caps and a new plan with new incentives is needed.

##### **A. Existing Price Cap Regulation Has Failed Rural America.**

###### **1. Few Rural ILECs Have Elected Price Cap Regulation for Interstate Services.**

Today, despite a decade of efforts to encourage independent ILECs to elect price caps, only a handful have done so. The vast majority (more than 1,300) have concluded that price cap regulation is simply unworkable for a substantial portion of their study areas and, as a result of the Commission's price cap all-or-nothing rule, they simply cannot make the transition, even though price cap regulation might be a rational alternative for certain of their individual study areas. At the state level the Joint Commenters in many cases have been able to elect alternative regulation on a study area-specific basis.

###### **2. Existing Price Cap Regulation Discourages Investment in New Infrastructure and Services**

Price cap regulation in its current form simply has not been effective at aligning carrier interests with those of rural consumers. When the Commission adopted price cap

regulation, one stated goal was to create a system that would “avoid the perverse incentives of rate-of-return regulation” for carriers to “gold-plate” their networks.<sup>14</sup> The primary problem with price cap regulation, however, is that it discourages large carriers from investing in the highest-cost parts of their study areas. Thus, the implementation of price caps has caused carriers to allow those high-cost exchanges to deteriorate.

Indeed, over the last ten years investment in rural areas served by price cap carriers has dropped sharply, and complaints have increased dramatically in these areas.<sup>15</sup> Under rate-of-return regulation, carriers invest in plant and equipment routinely to maintain or improve service quality, launch additional services in order to grow revenue, comply with state service quality

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<sup>14</sup> See *CALLS Order*, 15 FCC Rcd at 12968, ¶ 14; *LEC Price Cap Order*, 5 FCC Rcd at 6790, ¶ 29 (“Our own experience with administering a rate of return system convinces us that carriers in fact attribute unnecessary costs to their operations in an effort to generate more revenue.”).

<sup>15</sup> See *Access Charge Reform*, CC Docket No. 96-262, Comments of CenturyTel, Inc. (filed Jan. 22, 2002) at 2-3 (“[h]aving purchased the majority of its rural exchange lines from price cap carriers, CenturyTel has observed that rural exchanges divested from the larger companies often are in areas where the sellers have invested the least” and “divested loops in many areas [are] fully exhausted” such that they require the purchaser to “reinforce the loop, install new fiber, and drop in remote terminals” before the customers can receive basic services required under universal service obligations.); Iowa Telecommunications Services, Inc., Emergency Petition for Forbearance (filed Nov. 26, 2001) (noting that divested rural exchanges often require substantial upgrades); *Legg Mason Report* at 21 (observing that “[r]ural line consolidators have reported regularly that the plant acquired from the [BOCs] requires significant repair to meet minimum service standards,” and that “[v]arious state public service commissions (e.g. Minnesota, Arizona, California and Oregon) . . . have refused to permits sales [of the BOCs exchanges] until certain minimum standards were met by the selling [BOC].”); Alisa Blackwood, *US West Under Attack in Arizona*, Associated Press, 2000 WL 4474806 (Feb. 18, 2000) (Arizona, Colorado, Washington, New Mexico and Oregon “have taken US West to task for complaints, delays, and other quality of service problems.” Complaints have been originating “mostly in rural areas”); *Quality of Service of the Local Operating Companies*, Federal Communications Commission, Common Carrier Bureau, Industry Analysis Division (Dec. 2001), at 7 (showing the continued high level of

requirements, and maintain their business reputation. Under price caps, a carrier will be willing to make these types of investments only in areas: (a) that are central to the carrier's long-term growth strategy; (b) where competitors provide a sufficient threat to make such investment essential; and (c) where their costs are relatively "low."<sup>16</sup> In rural areas outside their strategic core markets, faced with the Commission's declining (and capped) rates, and higher-than-average costs, the Bell Operating Companies have been largely unwilling to make this commitment.<sup>17</sup> The result is that the BOCs have neglected their most rural exchanges for a decade, having determined instead to cut costs in those exchanges to the bare minimum and divest them whenever possible.<sup>18</sup>

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customer dissatisfaction with ILEC service and noting the "sharp increase in customer complaints observed in the SBC Ameritech Region").

<sup>16</sup> Price caps are, in this sense, the analogues of rent control, and there is no doubt that rent control laws discourage maintenance and delay improvements. As one commentator has explained, "[w]hen rent control reduces the expected lifetime earnings from [useful] property, it thereby reduces the optimal life of the asset. . . . Rational owners will respond by cutting back their reinvestment in maintenance. . . . The net result, according to one study, is that '[e]ach year 8 percent of the gap between the current level of housing services and the lower level supported by controlled rents is closed by deterioration.'" R. S. Radford, *Regulatory Takings Law In The 1990's: The Death Of Rent Control*, 21 S.W.U. L. Rev. 1019 (1992). *See also* C. Peter Rydell & Kevin Neels, *Direct Effects of Undermaintenance and Deterioration*, in *The Rent Control Debate* 91, 97 (Paul L. Niebanck ed. 1985).

<sup>17</sup> *See e.g., Legg Mason Report* at 20-21 (concluding after analyzing numerous ARMIS reports that in recent years "RBOC managements have directed resources to urban areas, where long-term strategic positioning is key and higher return on investment can be generated. As a result, it appears that rural investments have been minimal and, when the companies are pressed to upgrade non-urban properties, divestitures become a more logical outcome.")

<sup>18</sup> *Id.* at 156 ("[V]irtually every acquirer of RBOC lines has reported difficulties with cabling and serving electronics. VALOR reported that it was required to completely reinstall its outside plant in one region, where there was extensive use of lead cable.").

Thus, the BOCs have followed the incentives that price cap regulation created for them.<sup>19</sup> The Commission concluded in 1990 that price cap regulation would provide LECs with increased incentives to develop and introduce new services, invest in new technology, and to upgrade their networks because the price cap LECs “would be unlikely to jeopardize their network infrastructure, since it is their primary asset and is critical to their continued financial stability.”<sup>20</sup> The Commission failed to anticipate, however, that the price cap LECs, over the next ten years, would be unable to recover the costs of network investment in areas where their costs were highest. Accordingly, they were willing to let their rural networks languish and, ultimately, to sell them to carriers that specialize in providing rural telecommunications services.

As evidence of this phenomenon, for the past several years, the BOCs have actively been divesting exchanges in second- or third-tier markets which lie outside their core growth areas. More and more often, rate-of-return carriers that have years or decades of experience operating rural properties are the purchasers of these divested BOC exchanges. These transactions serve the public interest by affiliating these lines with others that have similar cost and service area characteristics operated by a carrier that values these lines as a core component of its growth strategy. The Commission has permitted these transactions to occur, perhaps in tacit acknowledgement that the large price cap carrier selling them considers these lines to be peripheral to its future growth, and operates under inexorable pressure to cut costs and

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<sup>19</sup> Indeed, the Commission, at the inception of price cap regulation, recognized these incentives and instituted mandatory service quality and infrastructure development reporting by price cap carriers precisely because it “recognized the theoretical concern that LECs under price cap regulation might seek to increase their profits not by becoming more productive, but by lowering the quality of the service they provide.” *LEC Price Cap Order*, 5 FCC Rcd at 6827, ¶ 334.

reduce investment in markets where its costs are above average. As a result of these transactions, millions of customers have gained access to such “new” and improved services as voice mail, caller ID, vertical features, and dial-up Internet access.<sup>21</sup> Thus, the realignment of rural lines away from the large price cap carriers and toward the rural-oriented independent carriers is a reality that the Commission should take into account in formulating policy.<sup>22</sup>

**B. The Competitive Environment Has Changed Dramatically Since the Commission First Adopted Price Cap Regulation for Large LECs.**

The Notice seeks comment on what circumstances and conditions have changed since 1990.<sup>23</sup> The answer is: *plenty*. Legal and regulatory changes have removed barriers to entry across the nation. As a result, the environment in which rate-of-return carriers operate has evolved substantially. The industry dynamics have changed and become significantly more competitive, usage of the PSTN has shifted, and legal and regulatory landscapes are considerably altered.

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<sup>20</sup> *Id.* at ¶ 335.

<sup>21</sup> See e.g., *CenturyTel of Northwest Arkansas, LLC, CenturyTel of Central Arkansas, LLC, and GTE Arkansas Incorporated, GTE Midwest Incorporated, GTE Southwest Incorporated, Joint Petition for Waiver of Definition of “Study Area” Contained in the Part 36 Appendix-Glossary of the Commission’s Rules; CenturyTel of Northwest Arkansas, LLC and Century Tel of Central Arkansas, LLC, Petition for Waiver of Sections 61.41(c) and 69.3(g)(2) of the Commission’s Rules*, Order, 15 FCC Rcd 25437, 25442, ¶ 13 (2000); *Telephone USA of Wisconsin, LLC and GTE North Incorporated, Joint Petition for Waiver of Definition of “Study Area” Contained in the Appendix to Part 36 of the Commission’s Rules (Glossary) and of Section 69.3(e)(9) of the Commission’s Rules; Telephone USA of Wisconsin, LLC, Petition for Waiver of Section 61.41(c) of the Commission’s Rules*, Order, 15 FCC Rcd 15032, 15036, ¶ 11 (2000).

<sup>22</sup> *Legg Mason Report* at 193 (BOCs likely to divest 10 million – 30 million lines over the next ten years).

<sup>23</sup> Notice at ¶ 266.

## **1. Legal and Regulatory Barriers to Competitive Entry Have Fallen**

Local telecommunications markets are now irrevocably open nationwide. The Telecommunications Act of 1996 made competition for switched local telecommunications services a leading policy goal in local exchange markets across the land.<sup>24</sup> To promote this policy, Congress enacted sections 251 and 252 of the Communications Act, which require all telecommunications carriers to interconnect,<sup>25</sup> and set forth additional duties of LECs in general, and ILECs in particular.<sup>26</sup> The statute requires ILECs to provide access to competitors to their poles, ducts, conduits, and rights-of-way at regulated rates,<sup>27</sup> permit resale of their services at wholesale-discounted rates,<sup>28</sup> provide local number portability,<sup>29</sup> upgrade their switches and databases to ensure local and toll dialing parity,<sup>30</sup> and compensate competitors for transport and termination of local telecommunications traffic.<sup>31</sup> Additionally, many rate-of-return ILECs<sup>32</sup> must

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<sup>24</sup> Congress enacted the 1996 Act to “promote competition and reduce regulation in order to secure lower prices and higher quality services for American telecommunications consumers and encourage the rapid deployment of new technologies.” Telecommunications Act of 1996, P.L. 104-104, 110 Stat. 56, Preamble.

<sup>25</sup> 47 U.S.C. § 251(a).

<sup>26</sup> 47 U.S.C. §§ 251(b), 251(c). Although rural ILECs are exempt from the specific ILEC duties in Section 251(c), this exemption may be terminated by a state public utility commission, 47 U.S.C. § 251(f)(1).

<sup>27</sup> 47 U.S.C. § 251(b)(4).

<sup>28</sup> 47 U.S.C. § 251(b)(1), (c)(4).

<sup>29</sup> 47 U.S.C. § 251(b)(2); 47 C.F.R. §§ 52.20-52.33.

<sup>30</sup> 47 U.S.C. § 251(b)(4); 47 C.F.R. §§ 51.205-51.215.

<sup>31</sup> 47 U.S.C. § 251(b)(5).

<sup>32</sup> Many of the Joint Commenters’ study areas do not benefit from the rural exemption contained in Section 251(f)(1), either because they do not meet the statutory definition of a rural telephone company, 47 U.S.C. § 153(37), or because that exemption has been terminated by a state commission.



comply with stringent ILEC-specific duties, such as to provide detailed disclosure of planned network changes,<sup>33</sup> negotiate and execute detailed interconnection agreements under the supervisory authority of the state public utility commissions,<sup>34</sup> unbundle myriad network elements at low, forward-looking prices,<sup>35</sup> and permit competitors to collocate equipment in ILEC central offices, requiring a detailed and operating understanding of building collocation space and designing contracts for the recovering of floor space, and power and environmental conditioning that meet stringent and complicated state and federal requirements.<sup>36</sup> Moreover, barriers to entry were made illegal, and the Commission has the explicit power to preempt any state or local statute or regulation that prohibits or has the effect of prohibiting any entity from providing interstate or intrastate telecommunications service.<sup>37</sup>

In addition, the Commission has made great efforts to align pricing with the way in which costs are incurred. Furthermore, the Commission has made universal service support more explicit, and portable to competitors. Furthermore, the *MAG Order* and *RTF Order* have created pro-competitive, deaveraged rates and universal service support based on the ILEC's costs that will further increase competition.<sup>38</sup>

## **2. Telecommunications Competition Has Grown Substantially in Rural America.**

CLECs, CMRS and other types of wireless carriers, cable television operators, and satellite broadband providers have all launched services in rural areas directly competitive to ILEC

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<sup>33</sup> 47 C.F.R. § 51.325-51.335.

<sup>34</sup> 47 U.S.C. §§ 251(c)(1), 252.

<sup>35</sup> 47 U.S.C. § 251(c)(3); 47 C.F.R. §§ 51.309-51.321, 51.501-51.515.

<sup>36</sup> 47 U.S.C. §§ 251(c)(6); 47 C.F.R. § 51.323.

<sup>37</sup> 47 U.S.C. § 253.

services. The presence or absence of a competing eligible telecommunications carrier (“ETC”), therefore, gives an incomplete picture at best of the true competitive landscape.<sup>39</sup> Whether or not these carriers have obtained certification as eligible telecommunications carriers, they are providing significant competition to rural ILEC services.

The impact of any level of competition in rural markets is relative to the size of the market. The loss of a single (and, perhaps, the only) large business customer in a rural industrial park, for example, can jeopardize the very financial stability of a rural carrier and severely tax its ability to meet its carrier of last resort obligations. Moreover, as has been amply demonstrated, even in more robust markets, even one competitor has the power to do severe damage to the incumbent’s business.<sup>40</sup> Declining growth can be traced to growing competition from the following sources:

CLECs and Cable System Operators. Today, CLECs have been authorized to provide service in all 50 states and the District of Columbia. The FCC now collects information from 86 wireline CLECs that, collectively, serve 8.5 percent of the nation’s 194 million access

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<sup>38</sup> *MAG Order*, 16 FCC Rcd 19613; *CALLS Order*, 15 FCC Rcd 12962.

<sup>39</sup> Notice at ¶ 257.

<sup>40</sup> See, e.g., News Release, *GCI Announces Record 2001 Results* (rel. Jan. 31, 2002) (claiming that General Communications, Inc., one competitor of mid-sized ILEC ACS of Anchorage, Inc., added more than 6,000 access lines during the fourth quarter and now has more than 79,000 access lines in service representing a 17 percent market share of total access lines in Alaska) (available at: [http://www.gci.com/about/press/4Q2001\\_pre.htm](http://www.gci.com/about/press/4Q2001_pre.htm)); News Release, *GCI Files Request to Provide Local Telephone Service in 10 Alaska Communities* (rel. Nov. 29, 2001) (GCI has constructed alternative telephone facilities utilizing a state-of-the-art digital switching platform connected via high-speed fiber optic rings and other transmission technologies, and seeks to serve Glacier State study area, encompassing 53,000 lines in the communities of Nenana, Ft. Greely, North Pole, Delta Junction, Kenai, Soldotna, Ninilchik, Homer, Seldovia and Kodiak.)

lines.<sup>41</sup> These statistics probably understate actual CLEC competition, as independent researchers have collected market and business information on over 200 facilities-based CLECs across the nation.<sup>42</sup>

Moreover, cable television system operators are increasingly broadening their range of services to include competitive voice telephony and are actively competing for data services provided via cable modems. In addition to competition from GCI, cited above, AT&T Broadband, Comcast, and other cable television system operators are now providing voice telephony over cable television plant.<sup>43</sup> Cable system operators have extensive wireline networks of their own that they are upgrading to provide voice telephony.<sup>44</sup>

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<sup>41</sup> *Local Telephone Competition: Status as of December 31, 2000*, Federal Communications Commission, Common Carrier Bureau, Industry Analysis Division (May, 2001) (“*Local Competition Report*”), at Tables 1 and 3.

<sup>42</sup> New Paradigm Resources Group, *The CLEC Report 2001*, 14<sup>th</sup> ed. (as described at <http://www.alts.com/ccanalysis/clecreport.htm>, listing 228 CLECs covered).

<sup>43</sup> See, e.g., News Release, *AT&T Details Results and Outlines Growth Plans For Broadband Business "More Than a Cable TV Company,"* AT&T Corp. (rel. July 31, 2001) (“As of June 30, [2001], AT&T Broadband had 848,000 broadband telephony customers . . .”) (available at: <http://www.att.com/press/item/0,1354,3921,00.html>); *Western Cable Show Wrap-Up*, Cable Datacom News (Dec. 1, 2001) (“Tollbridge Technologies announced that Comcast Corp. is conducting an IP telephony trial in Detroit, Mich. using its TB300 Voice Gateway. Comcast acquired the Detroit system from AT&T Broadband and currently serves some 30,000 circuit-switched telephone subscribers in the market.”) (available at: <http://www.cabledacomnews.com/dec01/dec01-4.html>); Press Release, *Motorola and Nortel Team to Deliver VoIP Solutions for Broadband-Cable Market* (rel. Feb. 4, 2002) (available at: [www.motorola.com/mediacenter/news/detail/0,1958,1049\\_762\\_23,00.html](http://www.motorola.com/mediacenter/news/detail/0,1958,1049_762_23,00.html)).

<sup>44</sup> See e.g., Lisa Madden, *The Packet and the Circuit Can Be Friends*, 23 N.H. Bus. Rev. 24 (Dec. 2001) (reporting that AT&T has already “deployed nearly 1.2 million circuit switches for voice subscribers over cable facilities” and that “[a]ccording to Deutsche Bank Alex Brown, voice subscribers [over cable] are expected to increase to more than 22 million by 2007 and Goldman Sachs says that cable operators' revenue will begin to surpass data revenues in 2003, reaching \$17 billion and 20 percent of total cable TV revenues by 2007”); Peter Huber, *AOL & Time Warner Inc.: The Death of Old Media*, Letter published January

CMRS and Other Wireless Providers. Wireless providers are providing increasingly stiff competition for ILECs across the country. At least 77 CMRS carriers now provide service to over 100 million subscribers,<sup>45</sup> and these CMRS carriers are siphoning a substantial amount of interstate access traffic off of the wireline network.<sup>46</sup> The Commission has cited evidence that “[i]n some areas, wireless use has begun to erode wireline revenue due to ‘technology substitution,’ that is, the substitution of new technologies for existing ones.”<sup>47</sup> Moreover, MMDS technology is expected to reach 90 percent of the U.S. population by the end of 2004.<sup>48</sup>

In addition, especially since 2000, when the Commission clarified procedures under which CMRS and other carriers may seek ETC certification,<sup>49</sup> state commissions and the

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11, 2000 (as of early in the year 2000 “[w]ell over one million homes already use cable modems, and another 200,000 subscribe to the main alternative, phone-line DSL”)

<sup>45</sup> *Local Competition Report* at Table 9.

<sup>46</sup> See *Sixth Annual CMRS Report* at 33 (“Twenty million mobile telephone customers have service plans that do not charge extra for long distance, and at least one analyst believes that such plans are reducing wireline long distance minutes and revenues.”) (citing Andrew Backover, *AT&T Loss Reflects Long-Distance Shift Consumers Turn To Calling Cards, Wireless*, USA TODAY, Jan. 30, 2001, at B3) (footnotes omitted).

<sup>47</sup> *Sixth Annual CMRS Report* at 32 (citing evidence that, “[f]or some, wireless service is no longer a complement to wireline service but has become the preferred method of communication. In a survey performed for the Consumer Electronics Association, three in 10 wireless phone users stated they would rather give up their home telephone than their wireless phone. Among wireless users aged 18 to 34 years old, that figure rose to 45 percent.”) (footnotes omitted).

<sup>48</sup> Michael Barlett, *Fixed Wireless System to Join Broadband Access Race – Study*, Newsbytes, Aug. 29, 2001 (citing Lindsay Schroth, an analyst with Yankee Group).

<sup>49</sup> *Federal-State Joint Board on Universal Service; Promoting Deployment and Subscribership in Unserved and Underserved Areas, Petitions for Designation as an Eligible Telecommunications Carrier and for Related Waivers to Provide Universal Service*, Twelfth Report and Order, Memorandum Opinion and Order, and Further Notice of Proposed Rulemaking, 15 FCC Rcd 12208, ¶¶ 95-99.

Commission have been certifying increasing numbers of competitive ETCs.<sup>50</sup> As the Commission has recently recognized, “[o]perators in the cellular and PCS bands have been granted ETC status and have become eligible for universal service funds, including Sprint PCS in California and Arkansas, United States Cellular Corp. in Washington, and Centennial Communications in Puerto Rico. As of year-end 2000, Western Wireless had received ETC approval in 10 states and had applications pending in three additional states.”<sup>51</sup>

Satellite Providers. Other technologies also pose competitive threats that augment those from wireline CLEC and CMRS providers. Satellite providers with nationwide footprints provide ready competition for ILEC broadband Internet access offerings.<sup>52</sup> Satellite providers

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<sup>50</sup> Numerous wireless companies have been certified as ETCs, making them eligible for Universal Service funds and positioning them to compete directly with ILEC wireline service. See e.g., *Petitions for Reconsideration of Western Wireless Corporation's Designation as an Eligible Telecommunications Carrier In the State of Wyoming*, Order on Reconsideration, 16 FCC Rcd 19144 (2001); *Western Wireless Corporation Petition For Designation As An Eligible Telecommunications Carrier For The Pine Ridge Reservation In South Dakota*, Memorandum Opinion and Order, 16 FCC Rcd 18133 (2001); *Minnesota Cellular Corporation's Petition for Designation as an Eligible Telecommunications Carrier*, Order Granting Preliminary Approval and Requiring Further Filings, Docket No. P-5695/M-98-1285 (Minn. PUC 1999); *Application of WWC Texas RSA Limited Partnership for Designation as an Eligible Telecommunications Carrier Pursuant to 47 U.S.C. § 214(e) and PUC Subst. R. 26.418*, Order, Docket No. 22289 (Texas Pub. Util. Comm'n 2000) (approving and affirming ETC designations).

<sup>51</sup> *Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993; Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services*, Sixth Report, FCC 01-192 (rel. June 20, 2001) (“*Sixth Annual CMRS Report*”), at Appendix A, p. A-6 (footnotes omitted); see also *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Public Notice, DA 01-409 (rel. Feb. 15, 2001) (seeking comment on CMRS carrier Smith-Bagley’s Petition for Agreement with Change in Definition of Rural LEC Service Areas in the State of Arizona (filed Feb. 1, 2001)).

<sup>52</sup> See e.g., [http://www.hns.com/direcway/for\\_home/home.htm](http://www.hns.com/direcway/for_home/home.htm) (providing detailed information about residential broadband satellite service that is currently available nationwide). In addition, over 50 million homes in the U.S. had access as of the end of 2001, see *Broadband*

project deployment of additional systems using the Ka-band that will be capable of providing residential and business advanced services over the next several years and some analysts predict that satellite systems will become a primary means of delivering high-speed data and Internet to rural America.<sup>53</sup>

### **3. Incentive Regulation Can Give Rural ILECs the Ability to Compete to Meet Rural Consumers' Telecommunications Needs.**

Rural consumers' telecommunications needs and expectations are changing, and rural ILECs need to find a way to better meet these needs. Today, rural business and residential telecommunications consumers are more likely than ever to substitute an alternate technology for services, such as interexchange calling, Internet browsing, instant messaging, wireless mobile "M-commerce," formerly provided using the ILEC's wireline connection.<sup>54</sup> Although the ILEC may be able to provide superior service, the Commission's current rules hamstringing the incumbent in competing for this business, both by limiting the ILEC's potential earnings (and, therefore, the

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*Advocates Should Fight to Increase Demand, Not Supply*, The Wall Street Journal, B1 (January 28, 2002).

<sup>53</sup> See *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, CC Docket No. 98-146, Third Report, FCC 02-33 (rel. Feb. 6, 2002) ("*Third 706 Report*"), at ¶ 77 (citing, as an example, two Ka-band services than plan introduction of service in 2003: WildBlue, an independent company with ties to EchoStar and News Corp., and Spaceway, to be provided by Hughes; Armand Musey, *The Satellite Model Book*, Salomon Smith Barney, Jun. 4, 2001, at 24; Thomas W. Watts and William W. Pitkin, *Global Satellite Marketplace 99: Clearing the Hurdles: The Satcom Industry Focuses on Execution*, Merrill Lynch, Apr. 14, 1999, at 99-101).

<sup>54</sup> See *Teens Join Phone Text Message Craze*, Associated Press, Yahoo! News (Jan. 31, 2002) (available at: [http://dailynews.yahoo.com/h/ap/20020131/tc/text\\_messaging\\_1.html](http://dailynews.yahoo.com/h/ap/20020131/tc/text_messaging_1.html)) (noting that Cingular Wireless estimates that its text message traffic increased 450 percent in the last six months).

amount of capital available for such investments), and by providing inadequate ability to respond to bundled and discounted competitive offerings.

As a result, the rapid growth in line counts and interstate minutes that was the hallmark of the 1990s has slowed or, in some cases, turned negative. CMRS carriers, which frequently permit large amounts of nationwide calling with no separate toll charges, have drained significant amounts of long distance traffic off the wireline network.<sup>55</sup> E-mail has supplanted a great deal of long-distance calling and largely replaced facsimile services, further reducing usage of the circuit-switched network. Consumers increasingly are turning to the world wide web to obtain information and order products that formerly would have involved a long-distance call. In January of this year, for example, AT&T cited “falling long-distance prices and the substitution of wireless and e-mail for traditional phone calls,” as well as a decline in 800-call volume, for an 18 percent decline in consumer long-distance revenue and 4.5 percent decline in business services revenue.<sup>56</sup> In addition, while still in its infancy, Internet- and internet-protocol

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<sup>55</sup> See e.g., Michelle Kessler, *Eighteen Percent See Cell Phones as Their Main Phones*, USA Today, January 31, 2002, (reporting poll results and fact that increasing use of wireless contributed to AT&T’s 9.5% drop in quarterly revenue) (available at <http://www.usatoday.com/money/tech/2002-02-01-cell-phones.htm>). Furthermore, costs for wireless long distance continue to fall as ease of service continues to increase. See e.g., *Verizon Wireless Sets New Nat’l Rate Plan*, Reuters, Yahoo! News, Jan. 31, 2002 (reporting that the nation’s largest wireless operator is introducing “a new national rate plan that will allow customers to use their cell phones on Verizon networks nationwide.”) (available at: [http://biz.yahoo.com/rf/020131/n31168053\\_1.html](http://biz.yahoo.com/rf/020131/n31168053_1.html)).

<sup>56</sup> See Deborah Solomon, *AT&T’s Quarterly Net Loss Narrows Despite Telecom Revenue Slowdown*, The Wall Street Journal, January 31, 2002 (report available at <http://online.wsj.com/article/0,4286,SB1012398828679710000,00.html?collection=wsjie/30day&vql-string=%28%22AT%26T%22%29%3Cin%3E%28article%2Dbody%29>).

telephony is expected to expand and allow users of high-speed Internet access services to eliminate the need for a dedicated voice line altogether.<sup>57</sup>

Based on observations of their traffic data, and as shown in the following chart, the Joint Commenters estimate that these developments have caused a decline of 10 to 15 percent in interstate minutes of use and continued declines are likely.<sup>58</sup>

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<sup>57</sup> See *Eighteen Percent See Cell Phones as Their Main Phones*, USA Today (quoting analyst's view that in the near future "[t]he vast majority of us are going to be using wireless phones as our main phones."); Dan Egbert, *The Spell of the Cell: Will 'Land Lines' Follow the Rotary Phone into Oblivion?*, The News & Observer (Raleigh NC) D1 (May 21, 2001) ("It is only a matter of time before wireline phones go the way of the old-fashioned rotaries and wireless phone usage will be ubiquitous," according to a recent Yankee Group report, which predicts that by 2005, usage of traditional phones will decrease 30 percent, replaced by wireless calling.")

<sup>58</sup> The Madison River ILECs, for example, experienced 10.72 percent growth, year-over-year, in total access minutes in 2000, after adjusting for acquisitions. This approximates the company's historical growth rate in access usage. During 2001, in contrast, growth declined to 1.84 percent, which is 8 percent to 10 percent below normal. Furthermore, in January, 2002, access minutes declined 7.09 percent from the level during same month in the prior year, supporting a conclusion that between 10 and 15 percent of access minutes have been lost to other technologies and competitors.



**NECA Common Line Pool**  
***Total Minutes of Use (in millions)***

Period	NECA CL POOL		Consistent Sample	
	MOU	Growth Rate	MOU	Growth Rate
<b>1998</b>	27,311.903		20,691.734	
<b>1999</b>	30,293.742	10.92%	22,660.216	9.51%
<b>2000</b>	32,360.168	6.82%	23,803.297	5.04%
<b>2001</b>	33,562.421	3.72%	24,398.354	2.50%

***Access Lines (in millions)***

Period	NECA CL POOL		Consistent Sample	
	LINES	Growth Rate	LINES	Growth Rate
<b>1998</b>	10.901		7.853	
<b>1999</b>	11.485	5.36%	8.265	5.25%
<b>2000</b>	12.07	5.09%	8.642	4.56%
<b>2001</b>	12.42	2.90%	8.892	2.89%

Source: Victor Glass, NECA, Inc., Connecting with Rural Telephone Companies, Presentation to Legg Mason Rural Telecommunications Conference, New York, Feb. 7, 2002, at 5. ("NECA CL Pool" statistics are computed based on all lines participating in the pool. "Consistent Sample" statistics are adjusted to take into account only study areas that participated in the pool for the entire 1998-2001 period.)

In sum, the Commission's policies and market forces have succeeded in dramatically reforming the competitive landscape for telecommunications services over the past decade. Competitive entry is a reality in most or all markets, when cable television, CMRS, satellite, and other providers are considered, and this competition is escalating. Furthermore, facilities-based CLECs have interconnection agreements and collocation arrangements in many rural study areas, and requests for interconnection pending in many more. The Commission's rules now should both reflect and facilitate this continuing trend.

## **V. The Commission Should Immediately Eliminate the Price-Cap All-or-Nothing Rules.**

As an initial step toward incentive regulation for rate-of-return carriers, the Commission should immediately eliminate the price cap “all-or-nothing” rule,<sup>59</sup> and the merger-and-acquisition “all-or-nothing” rule that requires the acquirer of a price cap company to convert all of its affiliated local exchange operating companies to price caps within one year.<sup>60</sup> These rules no longer serve the purpose for which they were originally adopted, and are inappropriate in light of the dramatic changes that have taken place in the regulatory and industry landscape since 1990.

### **A. The Commission’s Rule Reflects a Cautious Approach to Implementing Price Cap Regulation.**

When the Commission adopted its initial regulatory framework for price cap regulation in 1990, it recognized that incentive-based regulation could lead to greater innovation, lower rates for consumers, and reduced regulatory intervention.<sup>61</sup> Unlike rate-of-return regulation, price cap regulation has the advantage of providing incentives to regulated telephone companies to increase productivity by rewarding efficiency gains with the opportunity for a higher level of earnings.<sup>62</sup>

While price caps were made mandatory for the BOCs and GTE, the Commission gave other incumbent LECs the flexibility to elect price cap regulation, based in part on its conclusion that considerable diversity among smaller carriers made it difficult to predict with

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<sup>59</sup> 47 C.F.R. § 61.41(b)

<sup>60</sup> 47 C.F.R. § 61.41(c)(2)

<sup>61</sup> *Price Cap Order*, 5 FCC Rcd at 6790-91, ¶¶ 30-37.

certainty which could successfully operate under price caps.<sup>63</sup> It observed, for instance, that Cincinnati Bell and SNET served concentrated geographic areas, while others, such as Centel, provided service to more broad-based geographic areas.<sup>64</sup> Based on these findings, it concluded that few of the smaller rate-of-return carriers could successfully operate under mandatory price caps.

The flexibility to elect price caps was subject to two restrictions. First, all affiliated carriers (except average schedule companies) are required to elect price cap regulation simultaneously.<sup>65</sup> Second, a rate-of-return carrier that acquires a price cap carrier must convert all of its affiliates to price caps within one year.<sup>66</sup>

These restrictions were designed to prevent a carrier from operating some of its affiliated ILECs under price cap regulation, and some under rate-of-return regulation, because the Commission was concerned that, otherwise, a carrier might seek to shift costs improperly from its price cap affiliates to its rate-of-return affiliates.<sup>67</sup> The Commission feared that affiliated rate-of-return and price cap operating companies would have an incentive to engage in such cost-shifting and that, if such cost-shifting went undetected, customers of the rate-of-return affiliate might pay rates higher than otherwise could be justified, because costs otherwise

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<sup>62</sup> *Id.* at 6789, ¶ 22.

<sup>63</sup> *Id.* at 6818, ¶ 262-63; *see* 47 C.F.R. § 61.41(a)(3).

<sup>64</sup> *Id.*

<sup>65</sup> 47 C.F.R. § 61.41(b)

<sup>66</sup> 47 C.F.R. § 61.41(c)(2)

<sup>67</sup> *Id.* at 6819, ¶ 271. While the Notice also discusses the dangers of “fattening up” under rate-of-return regulation and “slimming down” under price caps, Notice at ¶ 261, this is a policy

properly allocated to the price cap affiliate would be included in the rate-of-return affiliate's rate base.<sup>68</sup> Accordingly, "out of an abundance of caution," the Commission adopted the price cap all-or-nothing rule to eliminate the incentive to engage in improper cost shifting.<sup>69</sup> As described below, the Commission's fears have proved ill-founded.

**B. The Regulatory Landscape Has Changed Fundamentally and Irreversibly Since 1990.**

In some cases, price cap regulation has become a highly useful tool for promoting both efficiency and competition in telecommunications markets because price cap regulation "mirrors the efficiency incentives found in competitive markets."<sup>70</sup> Further, since 1990, the Commission has taken extensive steps to reform its system of price cap regulation to facilitate the development of competition by (1) bringing rates more closely in line with the way costs are incurred, (2) reducing overall traffic-sensitive costs of access, (3) making explicit universal service support formerly implicit in interstate access rates, and (4) permitting increased pricing flexibility as competition develops. The Commission has also acknowledged the growing competition in local markets by allowing price cap carriers significant pricing flexibility.<sup>71</sup>

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concern associated with the "one-way door" rule, which the Joint Commenters do not discuss here.

<sup>68</sup> *Id.*

<sup>69</sup> *Id.* at 6819, ¶ 272.

<sup>70</sup> *Id.* at 6790, ¶ 33.

<sup>71</sup> *See Access Charge Reform*, Fifth Report and Order and Further Notice of Proposed Rulemaking, 14 FCC Rcd 14221 (1999) ("*Price Cap Pricing Flexibility Order*"), *aff'd sub nom. WorldCom, Inc. v. FCC*, 238 F.3d 449 (D.C.Cir. 2001); *see also ATU Telecommunications Request for Waiver of Sections 69.106(b) and 69.124(b)(1) of the Commission's Rules*, Order, 15 FCC Rcd 20655, 20661-62 (paras.19-21) (2000) ("*ATU Waiver Order*").

Even rate-of-return carriers have faced dramatic rate restructuring which encouraged competitive entry. Like the Commission's reforms for price cap carriers, the *MAG Order* realigned the interstate access charge rate structure more closely with the way costs are incurred, reduced overall traffic-sensitive carrier-paid access rates, and made additional universal service support explicit and portable to competitors.<sup>72</sup> Further, in the *RTF Order*, the Commission disaggregated explicit high-cost universal service support, making high-cost customers even more attractive targets for competing ETCs.<sup>73</sup> Moreover, legislators and regulators alike are demanding that carriers work to overcome the "digital divide," and make broadband technology universally available and affordable.<sup>74</sup>

### **C. The Industry Landscape Has Changed Dramatically Since 1990.**

These procompetitive changes have rendered the price cap all-or-nothing rule an anachronism that should be immediately eliminated. The Notice seeks comment on whether the price cap all-or-nothing rule<sup>75</sup> is "overly restrictive," "out of step with market realities," or

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<sup>72</sup> *MAG Order* at ¶ 15.

<sup>73</sup> *RTF Order*, 16 FCC Rcd at 11302, ¶ 144.

<sup>74</sup> At the federal level alone, at least twelve bills have been introduced in the 107th Congress that directly seek ways to stimulate broadband deployment, particularly in rural areas. See H.R. 496 (Independent Telecommunications Consumer Enhancement Act of 2001); S. 1359 (Facilitating Access to Speed Transmissions for Networks, E-commerce, and Telecommunications (FASTNet) Act); H.R. 1542 (Internet Freedom and Broadband Deployment Act of 2001); H.R. 1697 (Broadband Competition and Incentives Act of 2001); H.R. 1698 (American Broadband Competition Act of 2001); H.R. 1416 (Broadband Expansion Grant Initiative of 2001) (and companion legislation S. 428); H.R. 2038 (Rural Broadband Enhancement Act) (and companion legislation S. 966); S. 1056 (Community Telecommunications Planning Act of 2001); H.R. 267 (Broadband Internet Access Act of 2001) (and companion legislation S. 88).

<sup>75</sup> See 47 C.F.R. § 61.41.

“overshadowed by any regulatory inefficiency that may result” from its application.<sup>76</sup> The Joint Commenters believe that such is the case, and urge the Commission to repeal this rule.

As a result of ubiquitous competition from CMRS carriers, CLECs (including cable telephony providers), competitive ETCs, satellite service providers, and ISPs, cost-shifting would not be reasonable today.<sup>77</sup> Thus, the price cap all-or-nothing rule is an unnecessarily rigid mechanism for preventing cost shifting between price cap and rate-of-return-regulated affiliates. It prevents carriers and consumers alike from realizing the benefits of selective price cap election, despite the fact that it is no longer necessary to guard against cost-shifting. If these rules were eliminated, many more ILEC customers than is now the case could benefit from price cap regulation or a new incentive regulation program the Commission may adopt in this proceeding.

The Commission’s own experience over the past ten years shows that cost shifting concerns are overblown, and the rule should be repealed. Whether or not these regulations served as a deterrent to improper cost-shifting when price cap regulation was new and untested, the Commission has not enforced the all-or-nothing rule routinely in the merger-and-acquisition context. As a result, over the past three years, the Commission has gained substantial experience

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<sup>76</sup> Notice at ¶ 268.

<sup>77</sup> As evidence of this growing competitive pressure, the Joint Commenters point out that the Commission has recently found that ILECs do not over-invest in or, as the Commission sometimes terms it, “gold-plate” the network. While the Commission in 1990 found that this tendency existed and could be corrected by regulatory oversight, *LEC Price Cap Order*, 5 FCC Rcd at 6790, ¶ 29, the Commission concluded by 1999 that “virtually no carriers, rate-of-return carriers or others, are in fact attempting to ‘gold-plate’ their networks.” *Implementation of Section 402(b)(2)(A) of the Telecommunications Act of 1996*, Report and Order in CC Docket No. 97-11 and Second Memorandum Opinion and Order in AAD File No. 98-43, 14 FCC Rcd 11364, 11373, ¶ 13 (1999).

with carriers operating partly under price cap regulation and partly under rate-of-return regulation.<sup>78</sup> Since 1999, when a price cap carrier first began operating with a rate-of-return affiliate, the Commission has not identified any cost-shifting issue between affiliates. To the contrary, the Commission correctly found it unnecessary to impose structural or other safeguards when granting these waivers.<sup>79</sup>

Today, the BOCs are concentrating on evolving into global major-market telecommunications carriers, and price cap regulation has given these carriers incentives to avoid investment in their most rural exchanges, largely by divesting rural and high-cost exchanges. As a result, the Commission's all-or-nothing rules (which prevent the acquiring carrier from maintaining the regulatory status quo in its existing exchanges) deprive many ILEC customers – IXC's and end-users alike – of the potential benefits of price caps. Instead, rate-of-return carriers purchasing these exchanges must seek (and obtain) waivers of the price cap all-or-nothing rules, the “one-way door” rule,<sup>80</sup> or both, to return these exchanges to rate-of-return regulation

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<sup>78</sup> E.g., *ALLTEL Corp. Petition for Waiver of Section 61.41. of the Commission's Rules*, Order, 16 FCC Rcd 12407 (2001) (permitting ALLTEL, a rate-of-return carrier, to operate its affiliate, Aliant, under price caps following acquisition); *Puerto Rico Tel. Co. Petition for Waiver of Section 61.41 or Section 54.303(a) of the Commission's Rules*, Order, 16 FCC Rcd 12343 (2001) (permitting Puerto Rico Telephone Company to continue to operate under rate-of-return regulation following acquisition by price cap carrier); see also *ALLTEL Corp. Petition for Waiver of Section 61.41. of the Commission's Rules*, CCB/CPD No. 99-01, Order, DA 00-1307 (rel. June 16, 2000) (“*ALLTEL/Aliant Waiver Order*”); *Puerto Rico Tel. Co. Petition for Waiver of Section 61.41 or Section 54.303(a) of the Commission's Rules*, Order, 15 FCC Rcd 9680 (2000); *Puerto Rico Telephone Authority, Transferor, and GTE Holdings (Puerto Rico) LLC, Transferee, For Consent to Transfer Control of Licenses and Authorization Held by Puerto Rico Telephone Company and Celulares Telefónica, Inc.*, Memorandum Opinion and Order, 14 FCC Rcd 3122 (1999).

<sup>79</sup> E.g., *ALLTEL/Aliant Waiver Order*, DA 00-1307, at ¶ 6 (rejecting AT&T's request for structural separation and treatment of Aliant as a non-regulated affiliate).

<sup>80</sup> 47 C.F.R. § 61.41(d).

(because individual study areas could not survive under price caps. Even if such a carrier desires to continue operating the acquired exchanges under price caps, it must obtain a waiver to avoid converting their entire holding company to price cap regulation. Investors and analysts are sensitive to these waiver requests and those concerns may be reflected in higher cost of capital and lower stock prices. In granting these waivers, the Commission routinely acknowledges that they serve the public interest without risking harm to ratepayers.<sup>81</sup> As this divestiture trend accelerates, carriers must seek, and the Commission must address, a growing number of applications for waiver of the all-or-nothing rule, increasing the regulatory burden and business uncertainty this rule creates.<sup>82</sup>

**D. Adequate Safeguards Against Cost Shifting Exist Without the All-or-Nothing Rule.**

In addition to the competitive forces discussed above, other regulatory safeguards already in place also guard against cost-shifting and make the all-or-nothing rule a burdensome redundancy, at best. While the Notice properly notes that accounting and other non-structural safeguards may provide adequate safeguards against cost-shifting,<sup>83</sup> the Commission overlooks the fact that more robust safeguards are also already in place.

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<sup>81</sup> *E.g., ALLTEL Corp.*, Memorandum Opinion and Order, 14 FCC Rcd 14191, 14205, ¶ 37 (1999) (“*ALLTEL/Aliant Merger Order*”).

<sup>82</sup> *See, e.g.,* Public Notice, *ALLTEL Corporation Files a Petition to Waive Sections 61.41(b) and (c)(2)*, 16 FCC Rcd 21934 (2001); Public Notice, *CenturyTel Files Petitions to Waive the Commission’s “All-or-Nothing” Rule (Section 61.41) and Clarify the Availability of Interstate Access Universal Service Support (Section 54.801) for Exchanges to be Acquired in Missouri and Alabama*, CCB/CPD Nos. 01-30 and 01-36, DA 01-2974 (rel. Dec. 21, 2001) (“*CenturyTel Alabama/Missouri Public Notice*”).

<sup>83</sup> Notice at ¶ 264.



Separation between rate-of-return and price cap affiliates makes cost shifting eminently detectable and, therefore, unlikely. While the Joint Commenters do not suggest that the full panoply of separate affiliate safeguards that the Commission requires between LECs and affiliated IXCs should be formalized in the price cap all-or-nothing context,<sup>84</sup> many of these safeguards are, in fact, already in place. ALLTEL and Verizon, for example, already operate their price cap operating companies through separate corporate affiliates than their rate-of-return companies, and are likely to continue to do so.<sup>85</sup> Variations in state regulatory requirements, and accounting and tariffing differences make such separation virtually essential.

In other contexts, the Commission has recognized that this type of separation, with each affiliate maintaining separate books of account, is one means to ensure that costs are not improperly allocated.<sup>86</sup> As the Commission has recognized, with accounting separation, any attempt to shift costs from the price cap study areas to the rate-of-return study areas will be

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<sup>84</sup> See 47 C.F.R. § 64.1903(a).

<sup>85</sup> CenturyTel has proposed to do the same, *see CenturyTel Alabama/Missouri Public Notice*, DA 01-2974.

<sup>86</sup> See e.g., *Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace*, Second Report and Order In CC Docket No. 96-149 and Third Report And Order In CC Docket No. 96-61, 12 FCC Rcd 15756 (1997) ("*LEC Classification Order*") (deciding that separate affiliates with separate books of account sufficiently protects against improper allocation of costs between an incumbent LECs' local services and interexchange services); *Amendment of the Commission's Rules to Establish Competitive Service Safeguards for Local Exchange Carrier Provision of Commercial Mobile Radio Services*, Report and Order, 12 FCC Rcd 15668 (1997) ("*LEC-CMRS Order*") (local service and CMRS separation).

easily detectable.<sup>87</sup> There is no reason to believe that such separation would be any less effective here than in the other contexts in which it has been imposed, especially when the Commission's affiliate transaction rules will ensure that all transfers of services and assets will be done on an arms' length basis.<sup>88</sup>

The federal and state tariff review processes provide an additional safeguard by which to detect and deter improper cost allocation, and make additional reporting requirements unnecessary. Federal tariffs filed by rate-of-return companies include extensive cost support showing in detail how rates were calculated. Significant cost shifting would cause large year-over-year changes in this cost support that cause IXC's, consumer groups, Commission staff, and other interested parties to question the validity of the underlying cost allocation process. In such a case, the Commission has the authority to suspend and investigate any such tariffs that raise a substantial question of lawfulness under Section 204,<sup>89</sup> to prescribe just and reasonable rates under Section 205,<sup>90</sup> and to adjudicate complaints against carriers that improperly shift costs under Section 208.<sup>91</sup> Most states also conduct extensive review of LEC accounting, including cost allocation manuals and financial information, as well as state tariff filings. Any attempt by a rate-of-return LEC to pad its rate base would be detected in this review as well. Federal and state tariff reviews thus ensure that improper cost allocation between price cap and rate-of-return

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<sup>87</sup> *ALLTEL/Aliant Merger Order*, 14 FCC Rcd at 14205, ¶ 38 (observing that, while "[s]tructural separation does not cure the incentive to shift costs," it "makes cost shifting detectable").

<sup>88</sup> 47 C.F.R. §§ 32.27; 64.1903(a)(3).

<sup>89</sup> 47 U.S.C. § 204.

<sup>90</sup> 47 U.S.C. § 205.

<sup>91</sup> 47 U.S.C. § 208.

affiliates does not occur. Indeed, in light of these safeguards, many states allow the Joint Commenters to elect alternative regulation without requiring them to do so on an all-or-nothing basis.

The Commission has relied on the safeguards described above in many different contexts and has always found them sufficient to detect and deter improper cost shifting. In light of this positive experience, and the Commission's stated goal to rely more on enforcement efforts than on prophylactic regulation, it is clear that the price cap all-or-nothing rule is not a necessary safeguard to prevent improper cost shifting. The Joint Commenters urge its repeal.

**E. The Elimination of the Price Cap All-or-Nothing Rule Will Produce Benefits that Far Outweigh Any Remaining Usefulness of the Rule.**

The Commission's recognition that carriers other than the large BOC and GTE holding companies require additional flexibility remains valid today; rate-of-return holding companies operate some of the nation's smallest ILECs, which could not survive under price caps as it currently is formulated.<sup>92</sup> It does not serve the public interest, however, to prevent individual rate-of-return study areas from operating under a price cap or similar regime simply because all affiliated study areas cannot do the same. Providing flexibility to midsize LECs to elect such regulation on a study area basis also would enable price cap regulation (or other incentive regulation adopted by the Commission in this proceeding) to be implemented in areas where it cannot today. If a midsize LEC has the opportunity to gain experience with price cap regulation gradually, it also may ultimately choose to elect incentive regulation for additional

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<sup>92</sup> *Id.* at 6818, ¶ 262 (noting diversity of smaller LECs), 6820, ¶ 274 (noting frequent size disparities between affiliated operating companies of smaller LECs); *see also ALLTEL/Aliant Merger Order*, 14 FCC Rcd 14191.

study areas where conditions are suitable, providing additional benefits to customer in those study areas as well.

## **VI. The Commission Should Develop Incentive Regulation Tailored to Rural Carriers and Smaller Markets.**

After eliminating the price cap all-or-nothing rule to allow individual operating companies to elect an alternative to rate-of-return regulation where appropriate, the Commission should also develop a forward-thinking incentive regulation plan more closely tailored than the current price cap system to the needs of rural carriers and smaller markets in today's environment. The Joint Commenters believe that the Commission should first clearly articulate the goals it is pursuing for smaller markets, and then develop a set of guiding principles that advance these goals.

### **A. The Goals of Incentive Regulation Should Reflect the Realities of Rural and Small Urban Markets and Smaller Telephone Companies.**

Before the Commission can evaluate any particular incentive regulation proposal as it applies to rate-of-return carriers, it must develop a clear and well-articulated set of goals that it seeks to achieve. The Joint Commenters therefore applaud the Commission for including in the Notice a statement of the "Principles" it intends to apply in this proceeding.<sup>93</sup> As distilled from the Notice, the Commission states its intent to observe its statutory obligation to ensure that rates remain just and reasonable,<sup>94</sup> and seeks comment on the validity of the following additional goals: (1) to balance the rewards of incentive regulation against the risks involved;<sup>95</sup> (2) to promote investment necessary to maintain reasonable comparability of services between

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<sup>93</sup> Notice at ¶¶ 221-226.

<sup>94</sup> Notice at ¶ 221.

rural and urban areas;<sup>96</sup> (3) to maintain service quality and protect universal service;<sup>97</sup> (4) to expand the availability of new and advanced services to rural America and other areas served by rate-of-return carriers;<sup>98</sup> and (5) to minimize administrative burdens on small carriers. The Joint Commenters generally support these Commission goals, but believe that the Commission should pursue them within the context of rural and small urban markets in which these carriers operate. The Joint Commenters therefore offer the following considerations to supplement the Commission's stated goals:

**1. Just and Reasonable Rates.**

The Communications Act requires all carriers to ensure that their rates are just and reasonable.<sup>99</sup> The Commission states that, to ensure compliance with this standard, a carrier should share the benefits of incentive regulation equitably with its customers.<sup>100</sup> While the Joint Commenters agree that any regulatory plan should benefit consumers, the Commission should clarify two aspects of its interpretation of Section 201.

**a. Rate-of-Return Is Not the Only Valid Indicator of Just and Reasonable Rates.**

First, the Commission should clarify that, for rate-of-return carriers that elect incentive regulation, the Commission will no longer use the interstate rate-of-return as the primary indicator of whether the carrier's rates are just and reasonable. The Commission has

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<sup>95</sup> Notice at ¶ 222.

<sup>96</sup> Notice at ¶ 223.

<sup>97</sup> Notice at ¶ 224.

<sup>98</sup> *Id.*

<sup>99</sup> 47 U.S.C. § 201(b).

<sup>100</sup> Notice at ¶ 221.

held that compliance with Section 201 does not require adherence to any particular rate-of-return prescription. In adopting a price cap plan for the large LECs, the Commission held that local exchange carrier rates must remain within a “zone of reasonableness,” but need not produce any particular rate of return.<sup>101</sup> As the Commission has already recognized, this “zone of reasonableness” must *both* protect consumers against exploitative rates *and* preserve investor interests in maintaining the financial integrity of the company and preserving its access to capital markets.<sup>102</sup> The Commission has never held, however, that Section 201 itself requires any carrier to adhere to a particular rate of return. Rather, a prescribed rate-of-return is but one of many possible tools to ensure the reasonableness of rates.

**b. Investment in Rural Areas Is a Consumer Benefit Flowing from Properly-Designed Incentive Regulation.**

Second, the Commission should recognize that benefits to rural consumers may be realized and truly appreciated by means other than by lowering its interstate access rates. Specifically, rural consumers must have technology that keeps pace with a digital economy. Many customers in the Joint Commenters’ service areas would like access to higher modem transmission speeds, DSL capability, ATM, frame relay services, and other advanced services not yet available in rural areas. Yet, in many rural markets, substantial plant upgrades are required before the ILEC can make these services available. Long loop lengths impair the performance of digital subscriber line (DSL) or local dialup Internet services or prevent them from working at all, raising costly upgrade, maintenance, or plant redesign issues for rural

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<sup>101</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6787; *Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order, 4 FCC Rcd 2873, 2884, ¶ 19 (1989) (“*AT&T Price Cap Order*”).

<sup>102</sup> *Id.* at ¶ 17.

carriers.<sup>103</sup> In addition, in exchanges acquired from the BOCs, outside plant often is in such poor condition that neither digital subscriber line (DSL) nor local dial-up Internet access often can be made available without extensive plant upgrades.<sup>104</sup>

Deploying these services requires substantial new investment, and the subscription rate for new services is often quite low at first.<sup>105</sup> The Commission, therefore, should recognize that substantial benefits to consumers can flow from a properly-designed incentive regulation plan, even if carrier-paid interstate access rates do not immediately decline. By providing the opportunity for a carrier to increase its earnings on interstate access services, and tying earnings incentives to network capability and performance commitments, for example, incentive regulation can stimulate this type of investment.

## **2. Balancing Rewards and Risks.**

When balancing the rewards of incentive regulation against the risks the carriers assume in providing service, the Joint Commenters urge the Commission to consider the

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<sup>103</sup> See, e.g., *Legg Mason Study* at 146 (Open bridged tap “seriously damages higher-speed data communications” and its existence and location are frequently discovered only after a carrier tries to install high-speed service on the loop), 144 (load coils reduce or eliminate frequency transmission above approximately 3500 Hz.), 151 (“double-ended” digital loop carrier systems degrade modem performance below 28 Kbps); *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Comments of the Rural Utilities Service (filed Jan. 19, 2000), at 6 (Commission’s definition of voice grade access does not allow for 28.8 Kbps modem connectivity).

<sup>104</sup> See e.g., *Kendall Telephone, Inc. and Wisconsin Bell, Inc. Petition for Waiver of the Definition of “Study Area” Contained in Part 36, Appendix-Glossary of the Commission’s Rules*; and *Kendall Telephone, Inc. Petition for Waiver of Sections 61.41(c), 69.3(e)(6), and 69.3(g)(2) of the Commission’s Rules*, CC Docket No. 96-45 (Petition filed May 13, 1998), at 11-12.

<sup>105</sup> See e.g., *Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, CC Docket No.

increased risk already present in telecommunications markets served by rate-of-return LECs, in addition to the increased risk incentive regulation entails. Local telecommunications markets, even those in rural areas, have become increasingly risky since 1996. The state of the economy, particularly in rural areas, was uncertain even before September 11, 2001 and, since that time, it has plowed uncharted waters that even the best and most experienced economic experts have trouble reading.<sup>106</sup> Moreover, as discussed above,<sup>107</sup> the 1996 Act eliminated the monopoly status of *all* ILECs, and competition has been steadily growing, even in rural markets.

Thus, the Commission should adopt incentive regulation that balances the needs of ILEC customers against the risks borne by ILEC shareholders in a market that is no longer protected against competitive entry. Any new incentive regulation plan should afford adequate opportunities for ILECs to strive for benefits commensurate with this risk. The Joint Commenters commend the Commission on its proposal to make incentive regulation optional,<sup>108</sup>

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00-256, *Ex Parte* Presentation of CenturyTel, Inc., at 29 (filed Sept. 21, 2001) (showing DSL take rate below 1 percent in first year).

<sup>106</sup> See, e.g., *Regional Report: Where Will the Recovery Start?*, Wall Street Journal, January 23, 2002, at B12 (quoting economists who surmise that the recession will not end “until the Midwest and industrial South stop hemorrhaging jobs,” and warn of a “false dawn” caused by one-time events such as 0% financing for vehicles); Silvia Ascarelli, *European Investors Aren't Yet Convinced of a Recovery*, Wall Street Journal, January 14, 2002, at C10 (investors are skeptical that a recovery is underway, and that there substantial “fear that stock markets have anticipated too much too soon.”); Constance Mitchell Ford and Jon E. Hilsenrath, *Economic Forecasters Expect Moderate Recovery in 2002*, Wall Street Journal, January 4, 2002, at A2 (“economists are torn about the crosscurrents coursing through the economy” and that “in a sign of the uncertainty about this year's forecast, economists are once again divided into two distinct camps . . . .”); David Wessel, *Economists Confront Surplus of Uncertainty*, Wall Street Journal, November 1, 2001, at A1.

<sup>107</sup> See Section IV(B.), above.

<sup>108</sup> Notice at ¶ 227.



but the Joint Commenters believe that few rate-of-return carriers are likely to elect incentive regulation that does not strike the proper balance in this area.

**3. Promoting Reasonable Comparability of Services, Maintaining Service Quality, and Expanding Availability of New and Advanced Services.**

The failure of the current price cap system to advance these three related Commission goals in rural areas is well documented, above. The Joint Commenters, therefore, address these goals together to make one simple point: Not every alternative to rate-of-return regulation “gives rate-of-return carriers [incentives] to reduce investment in plant and equipment,”<sup>109</sup> or requires additional regulatory mandates and oversight to force carriers to maintain service quality or deploy new services. Rather than implementing a form of incentive regulation (such as price caps) that competes with these goals, therefore, the Commission should seek to build incentives into its regulations that encourage ILECs to pursue these goals independently. The Notice focuses too heavily on the Commission’s experience with existing price cap regulation. The Joint Commenters encourage the Commission to broaden its focus to consider ways in which its investment, service quality, and advanced services goals may be harmonized with an alternative regulatory system.

Carriers facing the proper incentives will pursue these goals eagerly. The Joint Commenters, therefore, urge the Commission to develop incentive rate regulation that rewards carriers that provide high-quality service and close the digital divide between rural and urban

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<sup>109</sup> Notice at ¶ 223.

areas.<sup>110</sup> By doing so, the Commission will also create a powerful mechanism to advance other goals of the 1996 Act, including reasonable comparability of services between urban and rural areas,<sup>111</sup> availability of advanced telecommunications and information services nationwide,<sup>112</sup> and deployment of advanced telecommunications capability to all Americans.<sup>113</sup>

#### **4. Minimizing Administrative Burdens.**

The Joint Commenters enthusiastically support this goal. To minimize administrative burdens, the Commission should, to the greatest extent possible: (a) avoid imposing additional reporting requirements that would duplicate or substantially overlap state requirements; and (b) develop incentive regulation that minimizes the need for monitoring and compliance enforcement by incorporating self-implementing incentives that promote the Commission's other goals.

Even the largest rate-of-return holding companies are considerably smaller than the smallest of the former Bell System Regional Holding Companies,<sup>114</sup> and the Commission has already recognized in many contexts that the burdens of rules designed for larger carriers

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<sup>110</sup> *Third 706 Report*, at Appendix C, Table 11 (data show that fewer than only 36.8 percent of ZIP codes with the lowest population density have at least one subscriber to high-speed service, defined as a transmission rate of at least 200 kbps in at least one direction).

<sup>111</sup> 47 U.S.C. § 254(b)(3).

<sup>112</sup> 47 U.S.C. § 254(b)(2).

<sup>113</sup> 47 U.S.C. § 157 note (enacted as Section 706 of the Telecommunications Act of 1996, P.L. 104-104, 110 Stat. 56 (1996)) ("Section 706").

<sup>114</sup> As of December 31, 1999, the smallest Regional Holding Company, Qwest, served 9.13 percent of the nation's access lines, while the largest rate-of-return carrier, ALLTEL, served only 1.23 percent. *Trends in Telephone Service*, Federal Communications Commission, Common Carrier Bureau, Industry Analysis Division (rel. Aug. 2001), at Table 8.3.

substantially outweigh their benefits when applied to such “mid-sized” carriers.<sup>115</sup> The Commission should therefore seek a form of incentive regulation for rate-of-return carriers that does not require extensive reporting, monitoring, or other regulatory filings but, rather, causes the carriers, acting in their own interests, to pursue the Commission’s other goals. In other words, the best incentive plan would be one that promotes the Commission’s public interest goals even when carriers act in their own self-interest, avoiding the need for monitoring the carriers’ activities.

**B. In Creating Incentive Regulation for Rate-of-Return ILECs, the Commission Should Adhere to Core Principles that Will Advance its Goals.**

The Joint Commenters do not support a price cap-type plan, unless it is structured to meet the goals described above and to reflect the realities of rural markets and smaller carriers. The Joint Commenters believe that the following principles would advance the goals of incentive regulation for rate-of-return ILECs, and urge the Commission to adhere to them in developing such regulation.

**1. Incentive Regulation Should Reward Investment in Rural Infrastructure.**

The Commission must find a way to promote and reward investment in rural markets. Customers are demanding a range and quality of services that can only be provided using modern technology and infrastructure. Moreover, the 1996 Act requires that the

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<sup>115</sup> 47 C.F.R. Part 36 Appendix-Glossary. For example, the Commission recently concluded that the benefits of detailed ARMIS-style reports for mid-sized carriers would substantially outweigh the benefits the reports would produce *2000 Biennial Review – Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 2*, CC Docket No. 00-199, Report and Order in CC Docket Nos. 00-199, 979-12, and 80-286 and Further Notice of Proposed Rulemaking in CC Docket Nos. 00-199, 99-301, and 80-286, 16 FCC Rcd 11991 (2001) at ¶¶ 184-204 (“*Phase 2 Accounting Reform Order*”).

Commission accelerate the deployment of advanced services by removing barriers to infrastructure investment.<sup>116</sup>

Contrary to the Commission's assumption in the Notice, the incentive to "reduce investment in plant and equipment, or to reduce expenditures on maintaining service quality, in order to increase profits at the expense of maintaining adequate investment or service quality,"<sup>117</sup> is *not* an inherent characteristic of a properly-designed alternative regulation plan. Thus, the Commission focuses on the wrong part of the issue in seeking comment on monitoring requirements.<sup>118</sup> The Commission should focus on developing incentive regulation that directly rewards electing carriers for meeting specific service quality and infrastructure or network-capability goals, minimizing the need for monitoring or regulatory "strong-arm" tactics to "control any adverse effects of the new incentives."<sup>119</sup>

Incentive regulation for rate-of-return carriers that mimics the existing price cap rules, such as those that the Commission focuses on in the Notice, likely would not align carrier profit incentives with the Commission's investment and service quality goals. Many states, such as Wisconsin, however, have developed alternative regulatory structures that do align these interests. These regulatory structures tie annual rate adjustments to carrier performance, as

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<sup>116</sup> See 1996 Act, Section 706(b).

<sup>117</sup> Notice at ¶ 223.

<sup>118</sup> Notice at ¶ 239.

<sup>119</sup> *Id.*

measured against specific standards for service quality and facilities deployment.<sup>120</sup> The Commission should work toward developing a similar federal framework.

**2. Incentive Regulation Should Afford an Opportunity for Increased Rewards as Business Risk Increases.**

The Joint Commenters urge the Commission to develop incentive regulation that affords electing carriers the opportunity to earn increased rewards – in the form of increased earnings – in exchange for proceeding boldly in the face of new financial and competitive risks. Even in the face of this increased risk, the potential for increased earnings can drive investment in facilities to provide new, improved, and advanced services. As the risk associated with doing so increases, however, the potential reward must do so as well. Conversely, rate-of-return carriers have difficulty building the business case for new and advanced services when (a) future technologies, take rates, and infrastructure needs are uncertain; (b) the potential return is capped; and (c) demand growth, as measured by interstate minutes and lines has stalled.

Risk has arisen on two fronts. *First*, as described more fully above, market risk has increased dramatically since 1996, both as a result of competition and because the pace of technological evolution has quickened substantially. DSL service, for example, is costly to roll out, requires substantial investment in new equipment, and necessitates upgrades or conditioning of outside plant. Even if the carrier makes these investments, moreover, the take rate among

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<sup>120</sup> For example, in Wisconsin, CenturyTel may adjust its intrastate rates based on its performance against certain investment and service quality metrics. *See, e.g., Application of CenturyTel of Wisconsin, Inc., for Approval of an Alternative Regulatory Plan*, Final Decision, 2930-TI-101 (Wisc. Pub. Serv. Comm’n Nov. 30, 1999).

customers is uncertain, the lifespan of the technology cannot be gauged, competition from lightly-regulated cable modem and satellite providers is fierce, and recovery is not guaranteed.<sup>121</sup>

*Second*, even with respect to basic telephone services, competition has grown in all areas of the country, as discussed in Section IV.(B.), above. Further, for virtually all rate-of-return carriers, line growth and minute growth have stalled as a result of growing consumer willingness to adopt CMRS technology as a second “line” and for long-distance calling.<sup>122</sup> Particularly as increasing numbers of CMRS carriers achieve ETC status,<sup>123</sup> this competitive

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<sup>121</sup> If the market fails to adopt the new technology in which the LEC has invested, LEC shareholders may ultimately bear the brunt of the resulting costs. For example, the Commission required price cap carriers to segregate investment, expenses, and revenue associated with video dialtone services in distinct, subsidiary accounts under the Uniform System of Accounts, *Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58 and Amendments of Parts 32, 36, 61, 64, and 69 of the Commission's Rules to Establish and Implement Regulatory Procedures for Video Dialtone Service*, Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 244, 325-26, ¶¶ 172-73. These costs were used exclusively to initialize rates for video dialtone service, which the Commission required the price cap LECs to place in a separate price cap basket for video dialtone services, *Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services under Price Cap Regulation*, Second Report and Order and Third Further Notice of Proposed Rulemaking, 10 FCC Rcd 11098, 11101, ¶ 15 (1995), and to isolate from the other price cap baskets when calculating interstate earnings for purposes of the sharing and low-end adjustment mechanisms, *id.* at ¶ 35. The Commission has already taken similar steps with respect to advanced services by establishing separate subaccounts within the USOA for packet switching equipment and optical circuit equipment, *Phase 2 Accounting Reform Order*, 16 FCC Rcd 19911 at ¶¶ 58, 61.

<sup>122</sup> See Section IV(B.)(3.), above.

<sup>123</sup> *Federal-State Joint Board on Universal Service; Promoting Deployment and Subscribership in Unserved and Underserved Areas, Including Tribal and Insular Areas*, Twelfth Report and Order, Memorandum Opinion and Order, and Further Notice of Proposed Rulemaking, 15 FCC Rcd 12208, 12263-69 ¶¶ 112-127 (2000).

battle is likely to increase in ferocity. Many rate-of-return ILECs face head-to-head competitors for basic residential and business services throughout large portions of their service territories.<sup>124</sup>

To provide a compensation structure that recognizes the increased risks facing a rate-of-return ILEC that elects incentive-based alternative rate regulation in the face of this growing competition, the Commission should therefore break the cap on earnings that is the hallmark of rate-of-return regulation today. As discussed in Section VI(A)(1.), above, and as the Commission concluded when it adopted price caps, such a cap is not the only way to ensure that rates remain just and reasonable under Section 201 of the Communications Act. Rate regulation that provides earnings flexibility in exchange for meeting service deployment and service quality targets in the face of mounting competition can also lead to just and reasonable rates.<sup>125</sup> Such an incentive regulation plan would continue to ensure that rates remain just and reasonable, as long as incentive-based rates are initialized based on cost-based rates at the outset of the plan.<sup>126</sup>

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<sup>124</sup> For example, Anchorage (served by ACS of Anchorage, Inc.) is among the most competitive markets in the nation. The Commission has already found that competition in the Anchorage market precludes uneconomic pricing and provides every Anchorage customer – residential and business alike – with at least two choices of local telecommunications service provider. *ATU Waiver Order*, 15 FCC Rcd at 20661-62, ¶¶ 19-21 (competitor collocated in 100 percent of wire centers and providing service to over 15 percent of Anchorage market, making it “it unlikely that [ACS] could lock-up the market and preclude competition from developing further”).

<sup>125</sup> See e.g., *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14234, ¶ 24 (granting additional pricing flexibility to price cap carriers that make a competitive showing); *Access Charge Reform*, First Report and Order, 12 FCC Rcd 15982, 16094, ¶ 263 (1997) (primarily relying on market forces to drive interstate access rates toward forward-looking cost), *aff’d sub nom. Southwestern Bell Tel. Co. v. FCC*, 153 F.3d 523 (8<sup>th</sup> Cir. 1998).

<sup>126</sup> Notice at ¶ 221; *LEC Price Cap Order*, 5 FCC Rcd at 6787.

### **3. Incentive Regulation Should Provide Support for New Investment.**

Investment in rural networks is costly. Even under incentive regulation, carriers will not make this investment unless it is reasonable from a business perspective to do so. While part of this incentive could come from an incentive plan that adjusts rates based on carrier investment and service quality performance, the Commission should make a portion available from universal service mechanisms. Section 254 of the Communications Act requires universal service support to be sufficient to ensure that *rates* (in addition to services) are reasonably comparable between urban and rural areas.<sup>127</sup>

Accordingly, to ensure compliance with Section 254's mandate, the Commission should pledge to support carriers that are willing to make the commitment to invest, in two ways. *First*, the Commission should adopt its proposal to incorporate a low-end adjustment mechanism in any alternative incentive plan.<sup>128</sup> Because of market uncertainties and risk, adopting a plan that lacks a low-end adjustment mechanism would create serious disincentives to carrier election of incentive regulation and could constitute confiscatory ratemaking.<sup>129</sup>

The Joint Commenters believe that the low-end adjustment mechanism should be triggered at earnings levels below 10.25 percent. This earnings level, 100 basis points below the Commission's rate-of-return prescription for rate-of-return carriers, is the earnings level that

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<sup>127</sup> 47 U.S.C. § 254(b)(3), 254(e).

<sup>128</sup> Notice at ¶ 238.

<sup>129</sup> See e.g., *Duquesne*, 488 U.S. 299; *LEC Price Cap Order*, 5 FCC Rcd at 6807, ¶ 164 (setting lower formula adjustment mark at level "not so low as to cause a confiscatory result in the short run.").



historically has triggered the low-end adjustment mechanism under price cap regulation.<sup>130</sup> As shown in the record compiled in the Commission's recent examination of the interstate authorized rate-of-return prescription, 11.25 percent is a reasonable estimate of the cost of capital for rate-of-return carriers.<sup>131</sup> Were rate-of-return ILEC earnings to fall substantially below that level, the ILEC's ability to invest in infrastructure, gain access to capital markets, and maintain high service quality would be at risk.

*Second*, the Commission should also provide carriers with the ability to receive universal service support that reflects these higher costs. This principle is necessary both to provide the incentive to expand the capabilities of rural networks, as discussed above, and to ensure compliance with the statutory principle of reasonable comparability.<sup>132</sup>

#### **4. Incentive Regulation Should Permit Market Pricing of Services.**

The Joint Commenters support the Commission's decision to extend its consideration of pricing flexibility issues to rate-of-return carriers.<sup>133</sup> Incentive regulation for rate-of-return carriers should incorporate pricing flexibility provisions that will allow market-based pricing of services.

The benefits of pricing flexibility are well-recognized by the Commission.<sup>134</sup> The Commission has long recognized that pricing of services should reflect the way in which costs

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<sup>130</sup> *LEC Price Cap Order*, 5 FCC Rcd at 6807, ¶ 165; *see also MAG Order* at ¶¶ 208-210 (terminating examination of authorized rate-of-return issues without altering the current 11.25 prescription).

<sup>131</sup> *MAG Order* at ¶ 209.

<sup>132</sup> 47 U.S.C. § 254(b)(3).

<sup>133</sup> Notice at ¶ 246.

<sup>134</sup> *E.g.*, Notice at ¶ 249; *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14263, ¶ 79.

are incurred.<sup>135</sup> The three forms of pricing flexibility the Commission proposes in the Notice, geographic deaveraging, volume and term discounts, and contract pricing, all would increase the efficiency of the interstate rate structure by moving rates closer to actual costs.<sup>136</sup> Geographic rate deaveraging would more closely align rates with costs by permitting carriers to differentiate traffic-sensitive rates within a study area according to higher and lower cost zones.<sup>137</sup> Similarly, the Commission has long recognized that volume and term discounts permit pricing to reflect LEC cost savings created by the efficiency and certainty of a long-term or volume commitment.<sup>138</sup> Finally, contract-based pricing permits carriers to respond to requests for proposals and develop complex service offerings more closely tailored to individual customer needs.<sup>139</sup>

By allowing prices to more closely track costs of serving particular customers, all of these forms of pricing flexibility also would eliminate implicit support that currently is

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<sup>135</sup> *E.g., Competitive Telecommunications Ass'n v. FCC*, 87 F.3d 522, 536 (D.C. Cir. 1996); *Access Charge Reform Order*, 12 FCC Rcd 15982, 15992, ¶ 24.

<sup>136</sup> Notice at ¶ 249.

<sup>137</sup> *MAG Order* at ¶¶ 57-60 (permitting rate-of-return carriers to deaverage common line charges (*i.e.*, the SLC) into cost zones); *CALLS Order*, 15 FCC Rcd at 13007-08, ¶¶ 113-115 (same). Because most rate-of-return LECs charge SLCs that are at the SLC cap, however, and because no deaveraged SLC may exceed the SLC cap, *MAG Order* at ¶ 59, few rate-of-return ILECs are able to take advantage of this pricing flexibility. *See* n.151, below.

<sup>138</sup> *See, e.g., Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14289, ¶ 124.

<sup>139</sup> *See* Notice at ¶ 249; *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14291 ¶128, 14293 ¶ 133; *AT&T Communications, Revisions to Tariff F.C.C. No. 12*, Memorandum Opinion and Order on Remand, 6 FCC Rcd 7039, para. 66 (1991) (“*Tariff 12 Remand Order*”) (A common carrier may supplement its generic offerings with offerings that are designed to meet the needs of a particular customer or limited number of customers without violating the unreasonable discrimination prohibition if that carrier makes that more customized offering available to anyone who might find it useful and the offering is not otherwise unlawfully

inherent in the interstate rate structure. The Commission, in finding that pricing flexibility increases efficiency of the interstate rate structure, tacitly concedes that the current structure contains inefficient support.<sup>140</sup> The Commission has long recognized geographic rate averaging as a form of implicit universal service support that requires some customers to pay above-cost rates to subsidize higher-cost customers elsewhere.<sup>141</sup> Furthermore, by denying LECs the ability to offer volume and term discounts and contract-based pricing, the Commission requires a customer that is willing to purchase a lower-cost service instead to purchase a higher-cost one, subsidizing customers that will not make the same volume, term, or specialized service commitment.

The Joint Commenters concur with the Commission's assessment that the competitive triggers the Commission used for price cap carriers are overly restrictive for rate-of-return carriers.<sup>142</sup> In rural areas, collocation is not necessarily an accurate measure of competition. Many rural competitors, including wireless ETCs and traditional CMRS carriers, do not collocate at the ILEC central office, preferring instead to execute traffic exchange agreements that include other types of interconnection arrangements. In addition, rate-of-return ILECs frequently have only a few central offices, making percentage measurements less meaningful as applied to these carriers.

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discriminatory.), *aff'd sub nom. Competitive Telecommunications Ass'n v. FCC*, 998 F.2d 1058 (D.C. Cir. 1993).

<sup>140</sup> Notice at ¶ 249.

<sup>141</sup> *E.g., Federal-State Joint Board on Universal Service*, Ninth Report and Order and Eighteenth Order on Reconsideration, 14 FCC Rcd 20432, 20441, ¶ 15 (1999), *remanded on other grounds sub nom. Qwest Corp. v. FCC*, 258 F.3d 1191 (10th Cir. 2001).

<sup>142</sup> Notice at ¶ 257.

Instead of counting collocating CLECs, the Commission should have a flexible standard for pricing flexibility that recognizes a variety of market-opening indicators, such as the presence of a competing ETC, the filing by the ILEC of a collocation and interconnection tariff, or the ILEC's renunciation of the rural exemption under section 251(f)(1). Any of these thresholds should be adequate to establish that a rural market is open to competition, regardless of how many competitors are in the market at any given time, and the Commission should adopt a flexible approach, finding that a rural ILEC that meets any one of them has opened its market to competition sufficiently to warrant pricing flexibility. So long as there are no barriers to entry, the threat of competition places constraints on ILEC pricing.

Rate-of-return operating companies that elect incentive regulation should not be limited to "downward-only" pricing flexibility, at least not as formulated in the Commission's recent *ATU Waiver Order*.<sup>143</sup> The Commission imposed this restriction in the *ATU Waiver Order* out of an abundance of caution, to ensure that a rate-of-return carrier that lowered prices for a high-volume or long-term customer could not then increase prices on other customers to restore its overall rate of return to 11.25 percent. The Commission seeks comment on whether such a restriction would "preclude anti-competitive behavior," if applied to ILECs generally,<sup>144</sup> but wholly disregards the fact that incentive regulation, however structured, attenuates the link between rates and costs. As noted above, incentive regulation should focus on investment rather than earnings or costs, especially when competitive entry is a deterrent to above-cost pricing.<sup>145</sup>

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<sup>143</sup> 15 FCC Rcd at 20662, ¶ 22.

<sup>144</sup> Notice at ¶ 251.

<sup>145</sup> The Commission found no such restriction necessary in the context of pricing flexibility for price cap carriers, instead concluding, for example, that "permitting volume and term

It is clear that the Commission has found that “downward-only” limitations are unnecessary for carriers that have elected incentive regulation.<sup>146</sup>

**5. Carriers Electing Incentive Regulation Should Share the Benefits of Such Regulation with Consumers, IXC Customers, ISPs, and CLECs.**

The Joint Commenters recommend that the Commission incorporate into any alternative regulatory plan for rate-of-return carriers a mechanism to allocate the benefits of incentive regulation between shareholders, consumers, IXCs, CLECs, and ISPs alike. In response to the Commission’s request for comment,<sup>147</sup> the Joint Commenters believe that such a mechanism does not need to incorporate an initial rate reduction or a recurring productivity offset. Rather, the Commission should confirm that other LEC actions can afford benefits to these groups.

Consumers. It is beyond argument that consumers will see little or no benefit either from an up-front “buy-in” on rate-of-return carrier interstate access rates or the application of a recurring X-factor. *First*, as discussed above, price cap regulation generally, and the X-factor in particular, create powerful pressures to reduce investment and expenses in rural service areas. These incentives have disserved rural America in the past, and should not be institutionalized in any new form of incentive regulation for rate-of-return carriers.

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discounts creates little headroom that an incumbent could use to increase rates for other access services.” *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14289, ¶ 124

<sup>146</sup> The Commission did eliminate the low-end adjustment mechanism for price cap LECs that obtain pricing flexibility. *Price Cap Pricing Flexibility Order*, 14 FCC Rcd at 14304, ¶ 162. The Joint Commenters may agree that some provision may be necessary to adjust for the effects of pricing flexibility if a rate-of-return carrier that has elected incentive regulation were to seek a low-end adjustment.

<sup>147</sup> Notice at ¶ 234.

*Second*, evidence before the Commission shows that small, rate-of-return ILECs not already subject to price caps do not experience the type of year-over-year productivity gains the BOCs can achieve.<sup>148</sup> Since 1991, at least three economic studies have shown that independent price cap carriers, such as Cincinnati Bell, Citizens, and Frontier, experience lower year-over-year productivity gains than do the Bell Operating Companies.<sup>149</sup> Further, there is no clear evidence before the Commission that rate-of-return LECs will experience any productivity gains whatsoever.

*Third*, simple mathematics dictate that interstate access rate reductions as a result of an initial “buy-in” or recurring productivity or glide path adjustment will provide no benefit to consumers. Certainly, there will be little impact on SLCs, because the X-factor seldom impacts end-user rates directly. During the 1990s, even for price cap carriers, interstate-allocated common line costs generally exceeded the caps the Commission placed on price cap carrier subscriber line charges. For rate-of-return carriers even more than price cap carriers, interstate-allocated common line costs generally exceed even the revised SLC caps adopted in the *MAG Order*.<sup>150</sup> Confirming this fact, NECA’s common line tariff, filed to take effect January 1, 2002,

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<sup>148</sup> See e.g., *CALLS Order*, 15 FCC Rcd at 13034, ¶ 173; *LEC Price Cap Order*, 5 FCC Rcd at 6799, ¶ 104.

<sup>149</sup> See *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, Comments of the Independent Telephone and Telecommunications Alliance (filed Jan. 7, 2000) at Appendices A, B, and C.

<sup>150</sup> *MAG Order* at ¶ 15.

shows that the vast majority of NECA common line pool participants charge SLCs at the SLC caps.<sup>151</sup>

Additionally, there is little chance that even a dramatic change in rate-of-return carrier-paid access charges could affect national long-distance pricing because price cap carriers served over 93 percent of the nation's access lines, as of December 31, 1999.<sup>152</sup> Given Section 254(g)'s requirement that IXC's charge nationally-integrated rates, it is extremely unlikely that an up-front "buy-in" or X-factor type productivity adjustment in that portion of rate-of-return carrier study areas that elect incentive regulation could have an impact on long-distance rates. Moreover, in the wake of substantial reductions in rate-of-return carrier traffic sensitive rates required by the *MAG Order* on January 1, 2002,<sup>153</sup> none of the major IXC's announced any significant reduction in long distance pricing.

Given this recent substantial reduction in carrier-paid interstate access charges, the Commission should refocus its objectives for the remainder of this proceeding on incentives that provide real service quality and deployment benefits to consumers. Such incentives would produce benefits for consumers in the form of upgraded infrastructure, new or improved services, and high service quality and customer service levels. Similarly, by providing pricing flexibility incentives, such as those discussed above, for rural, rate-of-return ILECs that

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<sup>151</sup> National Exchange Carrier Ass'n, FCC Tariff No. 5, Transmittal No. 919 (filed Dec. 17, 2001), at pp. 17-43 through 17-79 (showing nearly all NECA common line pool participants charging maximum permissible residential and multiline business SLC).

<sup>152</sup> *Trends in Telephone Service*, Federal Communications Commission, Common Carrier Bureau, Industry Analysis Division (rel. Aug. 2001), at Table 8.2 (showing that price cap carriers served 172,845,396 out of 184,985,055 access lines nationwide).

<sup>153</sup> Edie Herman, *FCC Adopts Access Charge Reform for Rural Telcos*, Communications Daily, Oct. 12, 2001, at 3.

undertake market-opening initiatives, the Commission would produce benefits to consumers in the form of more market-based pricing and increased competition.

Information Service Providers. As incentive regulation spurs carriers to expand and enhance the capabilities of their networks, ISPs will benefit from improved performance of information services and increased customer demand. Plant upgrades permit increased modem transmission speeds.<sup>154</sup> Moreover, expanded availability of high-speed or advanced services will further stimulate demand for information services, as these services make the Internet faster, increase its capabilities, and make the “world wide wait” a thing of the past.<sup>155</sup>

Interexchange Carriers. IXC's have already benefited from the Commission's shift of approximately \$900 million in interstate access costs onto the consumer in the *MAG Order*.<sup>156</sup> Incentive regulation that prompts carrier investment in the network may also reduce overall access costs further by eliminating the need, in some cases, for IXC's to interconnect with rural LEC's using a BOC-owned tandem switch. By encouraging facilities upgrades, incentive

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<sup>154</sup> See, e.g., *Common Carrier Bureau Seeks Comment on Requests to Redefine “Voice Grade Access” for Purposes of Universal Service Support*, CC Docket No. 96-45, Comments of the Rural Utilities Service (filed Jan. 19, 2000), at 6.

<sup>155</sup> SBC Communications Inc., *Fact Sheet on Emerging Broadband Applications* (Dec. 2000) (“The increasing availability of broadband service is spurring consumer demand for broadband-dependent applications, such as video messaging, home networking and wireless web devices.”) (available at: [http://www.sbc.com/Products\\_Services/DSL/Emerging\\_Broadband\\_Applications\\_Dec\\_2000.doc](http://www.sbc.com/Products_Services/DSL/Emerging_Broadband_Applications_Dec_2000.doc)); Mark Robichaux, *Telecommunications (A Special Report): Cable Connection*, Wall Street Journal, September 16, 1996 at R17 (“A big industry of suppliers is hoping that jaded on-line users tired of the ‘World Wide Wait’ will flock to the services once they get a taste of the high-speed offerings.”); Lee Gomes, *Intel to Introduce a Low-Cost System For Video Teleconferencing With PCs*, Wall Street Journal, May 30, 1996, at B16 (report that analyst Geoff Ballew believes that developments like data compression and cable modems will eventually improve the quality of video to home PCs and therefore spur demand. “There's a big demand, but only if the quality is good,” Mr. Ballew noted.).



regulation may make it more technologically- and economically-feasible for IXC's to interconnect directly with the rural LEC. Moreover, additional fiber deployment in rural markets, advanced switching capability, and increased network reliability and capacity will facilitate IXC's efforts to bring high-quality services to their rural customers.

An alternative regulation plan also increases predictability and stability of rates for IXC's. Under the current system of rate-of-return regulation, carrier traffic-sensitive access rates are likely to begin to rise as early as this summer. Growth in lines and interstate access minutes has dropped substantially and, in some cases, turned negative in the past year.<sup>157</sup> Rate-of-return carriers that must recover their traffic-sensitive revenue requirements over fewer minutes must do so by raising traffic-sensitive interstate access rates. Accordingly, even if incentive regulation does not include an X-factor or up-front buy-in, interexchange carriers are likely to benefit from rate regulation that both attenuates the link between costs and rates and increases the predictability and stability of interstate access costs.

Competitive Local Exchange Carriers. In rate-of-return carrier study areas not subject to the rural exemption, competitors will see clear benefits from alternative rate regulation that rewards ILECs for expanding the capabilities of their networks. CLECs that purchase unbundled loops will see the performance of DSL, dial-up Internet, and other data transmission services increase, much as the ILEC does. Furthermore, in rural areas, incentive regulation that ties pricing flexibility to market-opening commitments (such as certifying the presence of a

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<sup>156</sup> Edie Herman, *FCC Adopts Access Charge Reform for Rural Telcos*, Communications Daily, Oct. 12, 2001, at 3.

competing ETC, filing by the ILEC of a collocation and interconnection tariff, or renouncing the rural exemption under section 251(f)(1)) would produce undeniable benefits for CLECs. If rural ILECs were offered the opportunity to respond to competition in a meaningful manner through pricing flexibility, then these carriers would be more willing to take such market-opening steps, making competitive entry by wireline competitors even easier than it is today.

**6. Reform of Interstate Access Rate Regulation Should Proceed Hand-in-Hand with Reform of the Jurisdictional Separations Process.**

The Commission recently sought comment on several options for reform of the Commission's jurisdictional separations rules offered by the state members of the Federal-State Joint Board on Jurisdictional Separations ("Joint Board").<sup>158</sup> Some of these reforms would involve sweeping changes to the jurisdictional separations process and rules. Among the options offered by the state members of the Joint Board were a proposal to create a whole new separations methodology for packet-switched services, implement "facilities-based" separations, establish a "one-jurisdiction" framework in which all costs would be allocated to a single jurisdiction, or to eliminate separations entirely.<sup>159</sup>

The Joint Commenters believe that the Commission should develop incentive regulation for rate-of-return carriers *without waiting* until the current five-year freeze on jurisdictional separations allocation factors and optional freeze on jurisdictional separations

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<sup>157</sup> See, e.g., Victor Glass, NECA, Inc., *Connecting with Rural Telephone Companies*, Presentation to Legg Mason Rural Telecommunications Conference, New York, Feb. 7, 2002, at 5 (table reproduced at page 22, above).

<sup>158</sup> Public Notice, *Common Carrier Bureau Seeks Comment on "Glide Path" Policy Paper Filed by the State Members of the Federal-State Joint Board on Jurisdictional Separations*, CC Docket No. 80-286, DA 01-2973 (rel. Dec. 20, 2001).

<sup>159</sup> See *id.*

category relationships<sup>160</sup> has expired and further reforms have been put in place. Nevertheless, it is easiest for carriers to make correct assessments of the effects of any new form of interstate rate regulation, including incentive regulation, when interstate revenue requirements are stable, predictable, and not clouded by potential regulatory reform.

Therefore, the Joint Commenters recommend that the Commission incorporate into any incentive regulatory framework for rate-of-return carriers the ability to make exogenous changes to carrier-paid interstate access rates and/or universal service recovery to account for, at a minimum, legal and regulatory changes (such as jurisdictional separations rule changes) that impact interstate revenue requirements.<sup>161</sup> Furthermore, the Joint Commenters recommend that, at the inception of any incentive-based alternative rate regulation plan, the Commission afford electing carriers an additional opportunity to freeze category relationships, as it did when the current jurisdictional separations freeze took effect.<sup>162</sup>

## **VII. Conclusion.**

For the foregoing reasons, the Joint Commenters urge the Commission to (1) adopt an incentive-based alternative system of rate regulation that rate-of-return carriers may elect on a study area-by-study-area basis; (2) immediately eliminate the price cap all-or-nothing rules; (3) clearly articulate the goals of incentive regulation, informed by the legal, regulatory, market, economic, and technological forces rural carriers face; and (4) achieve these goals by developing

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<sup>160</sup> *Jurisdictional Separations Interim Freeze Order*, 16 FCC Rcd at 11387, ¶ 9

<sup>161</sup> The Joint Commenters believe that a set of changes analogous to the one set forth for price cap carriers in 47 C.F.R. § 61.45(d)(1) and tailored to the needs of rate-of-return carriers that have elected incentive regulation would be sufficient.

<sup>162</sup> *Jurisdictional Separations Interim Freeze Order*, 16 FCC Rcd at 11387, ¶ 9.

incentive regulation that rewards and supports rural investment in infrastructure, provides an opportunity for greater rewards as business risk increases, permits market-pricing of services, shares the benefits of incentive regulation among ILEC shareholders, consumers, IXCs, ISPs, and CLECs alike, and anticipates reforms to the jurisdictional separations rules.

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